

Four Dollars

T H E

Winter 1987

BROOKINGS

R E V I E W

Henry J. Aaron
on the Impossible Dream Come True:
The New Tax Reform Act

Joseph A. Pechman
on Tax Reform Prospects in Europe and Canada

A. James Reichley
on Post-Reagan Politics

Steven S. Smith
on O'Neill's Legacy for the House

Robert W. Crandall
on Telephone Rates After the AT&T Break-Up

Board of Trustees

Louis W. Cabot

Chairman

Ralph S. Saul

Vice Chairman

Chairman, Executive Committee

Chairman, Development Committee

Samuel H. Armacost

J. David Barnes

Rex J. Bates

Frank T. Cary

A. W. Clausen

William T. Coleman, Jr.

Lloyd N. Cutler

Thomas R. Donahue

Charles W. Duncan, Jr.

Walter Y. Elisha

Robert F. Erburu

Roberto C. Goizueta

Robert D. Haas

Philip M. Hawley

Roy M. Huffington

B. R. Inman

Vernon E. Jordan, Jr.

James A. Joseph

James T. Lynn

Bruce K. MacLaury

Donald F. McHenry

Mary Patterson McPherson

Maconda B. O'Connor

Donald S. Perkins

J. Woodward Redmond

James D. Robinson III

Robert V. Roosa

Henry B. Schacht

Howard R. Swearer

Morris Tanenbaum

James D. Wolfensohn

Ezra K. Zilkha

Charles J. Zwick

Honorary Trustees

Vincent M. Barnett, Jr.

Barton M. Biggs

Eugene R. Black

Robert D. Calkins

Edward W. Carter

Bruce B. Dayton

Douglas Dillon

Huntington Harris

Andrew Heiskell

Roger W. Heyns

John E. Lockwood

William McC. Martin, Jr.

Robert S. McNamara

Arjay Miller

Charles W. Robinson

H. Chapman Rose

Gerard C. Smith

Robert Brookings Smith

Sydney Stein, Jr.

Phyllis A. Wallace

❶ THE BROOKINGS INSTITUTION is a private nonprofit organization devoted to research, education, and publication on important issues of domestic and foreign policy. Its principal purpose is to bring knowledge to bear on the current and emerging policy problems facing the American people. Brookings functions as an independent analyst and critic, committed to publishing its research findings for the information of the public. In its educational activities, it works to bridge the gap between scholarship and policy-making, bringing new information and analyses to the attention of decision-makers in the public and private sectors. Its activities are carried out through three research programs (Economic Studies, Governmental Studies, Foreign Policy Studies), a Center for Public Policy Education, a Social Science Computation Center, and a Publications Program.

The Institution was incorporated in 1927 to merge the Institute for Government Research, founded in 1916 as the first private organization devoted to public policy issues at the national level; the Institute of Economics, established in 1922 to study economic problems; and the Robert Brookings Graduate School of Economics and Government, organized in 1924 as a pioneering experiment in training for public service. The consolidated institution was named in honor of Robert Somers Brookings (1850–1932), a St. Louis businessman whose leadership shaped the earlier organizations.

Brookings receives financial support from philanthropic foundations, corporations, and private individuals; it also draws funding for its activities from endowment income, conference fees, sales of publications, and charges for computer services. In addition, the Institution undertakes some unclassified government contract studies, reserving the right to publish its findings.

A board of trustees is responsible for general supervision of the Institution, approval of fields of investigation, and safeguarding of the Institution's independence. The president is the chief administrative officer, responsible for formulating and coordinating policies, recommending projects, and selecting the staff. In recent years the senior fellows and research associates have numbered about fifty men and women with varied backgrounds in the academic world, government, or both.

The officers and staff conduct a continual review of the Institution's fields of interest. Discussions with government officials, members of Congress, business leaders, foundation officers, and other scholars help to identify issues for study. Subjects are selected for study on the basis of their significance and timeliness, the adequacy of information and techniques of investigation, the availability of personnel and funds, and the relationship of the projects to the Institution's objectives. Each Brookings study is offered as a complete scholarly treatment of a subject worthy of public consideration; the Institution itself does not take positions on policy issues.

T H E
BROOKINGS
R E V I E W

Winter 1987 Vol. 5, No. 1

**3 The Impossible Dream Comes True:
The New Tax Reform Act**

Henry J. Aaron

11 Tax Reform Prospects in Europe and Canada

Joseph A. Pechman

20 Post-Reagan Politics

A. James Reichley

28 O'Neill's Legacy for the House

Steven S. Smith

37 Has the AT&T Break-Up Raised Telephone Rates?

Robert W. Crandall

45 New Publications

Henry J. Aaron and Cameran M. Lougy on comparable worth. Donald F. Barnett and Robert W. Crandall on steel minimills. Charles L. Schultze on inflation, wage behavior, and economic stability.

Brookings Books

Other Times, Other Places: Macroeconomic Lessons from U.S. and European History

Charles L. Schultze. 1986/\$7.95 paper/\$15.95 cloth

The Comparable Worth Controversy

Henry J. Aaron and Cameran M. Lougy. 1986/\$7.95 paper

Up from the Ashes: The Rise of the Steel Minimill in the United States

Donald F. Barnett and Robert W. Crandall. 1986/\$9.95 paper/\$26.95 cloth

Military Objectives in Soviet Foreign Policy

Michael McCWire. 1987/\$18.95 paper/\$39.95 cloth

Détente and Confrontation: American-Soviet Relations from Nixon to Reagan

Raymond L. Garthoff. 1985/\$18.95 paper/\$39.95 cloth

Strategy and Force Planning: The Case of the Persian Gulf

Joshua M. Epstein. 1987/\$10.95 paper/\$28.95 cloth

When Federalism Works

Paul E. Peterson, Barry G. Rabe, and Kenneth K. Wong.
1986/\$10.95 paper/\$28.95 cloth

Religion in American Public Life

A. James Reichley. 1985/\$11.95 paper/\$31.95 cloth

The New Direction in American Politics

John E. Chubb and Paul E. Peterson, Editors. 1985/\$9.95 paper/\$26.95 cloth

No. Copies	Author	Title	Price
_____	_____	_____	\$ _____
_____	_____	_____	_____
_____	_____	_____	_____

Postage and Handling **3.00**

Total \$ _____

_____ Payment enclosed Bill to my _____ MasterCard _____ VISA

_____ Exp. date _____

Signature _____ Phone # _____

Name _____

Address _____

City _____ State _____ Zip _____

Mail to: Cashier's Office
The Brookings Institution
1775 Massachusetts Avenue, N.W.
Washington, D.C. 20036

XREV51

The Brookings Review is published quarterly by the Brookings Institution, 1775 Massachusetts Avenue, N.W., Washington, D.C. 20036. Second-class postage paid at Washington, D.C. Copyright © 1986 by The Brookings Institution. All rights reserved.

President: Bruce K. MacLaury
Vice President — External Affairs:
John M. Hills

The Brookings Review
Publisher: Mark Goldberg
Editor: Martha V. Gottron
Production Staff:
Vickie L. Baily
C. Elizabeth Warner
Proofreaders:
Margaret Oosterman
Michael L. Pleasants
Charles Southwell

Designed by Meadows & Wiser

Second-class postage paid at Washington, D.C.
USPS I.D. No. 14209; Publication No. 551640;
ISSN 0745-1253
Subscription rates:
one year \$15 (\$20 foreign);
two years \$27 (\$37 foreign).
Send address changes to:
The Brookings Review
1775 Massachusetts Avenue, N.W.
Washington, D.C. 20036
U.S. newsstand distribution by Four Star News
Distributors, Inc., 33-30 57th Street, Woodside,
New York 11377.

The Impossible Dream Comes True: The New Tax Reform Act

Henry J. Aaron

LIKE THE BEWITCHED PRINCESS who watched endless suitors perish in the dragon's fire, advocates of tax equity and efficiency have despaired for decades as the occasional brave politician marched off on a futile quest for tax reform. In 1986, to almost universal surprise, the spell was broken. A bipartisan coalition of members of Congress and the president slew a host of political dragons and enacted a major tax overhaul that deserves to be honored as reform.

Any assessment of this landmark reform must address several broad questions: What was accomplished? What retrograde steps were mistakenly taken? What opportunities were missed? And how will the new tax law influence economic behavior?

To begin with, one should be clear on what the 1986 tax reform law is *not*. It is not a revolution in the American tax system in the sense that the introduction of a value-added tax or integration of the personal and corporate income taxes would be. It does not inaugurate a new era of simplicity. Nor will it launch the American economy into a new era of economic growth. It has not purged the tax system of distortions and illogic.

But the Tax Reform Act of 1986 stands as the most important improvement in the broad-based taxes on individual and corporate income in at least two decades. It deals in a fundamental way with many parts of the tax code that created widespread opportunities to avoid taxation and distorted the flow of investment into wasteful uses. By curtailing these provisions, the act makes possible a major reduction in statutory rates without loss of revenue or any decline in progressivity. Of the three stated goals of tax reform — to make the system more conducive to economic efficiency and growth, fairer, and simpler — the new law achieves major advances on the first and second and, on balance, modestly advances the third.

Elements of the Reform

The most important elements of the reform follow.

— Personal exemptions are increased from \$1,080 in 1986 to \$1,900 in 1987, \$1,950 in 1988, and \$2,000 in 1989, and the standard deduction is raised from \$3,670 for couples (\$2,480 for single persons) to \$5,000 for couples (\$3,000 for single persons) in 1988. The earned income tax credit is increased to 14 percent of earnings up to \$5,714 (a maximum credit in 1987 of \$800) and will be phased out, starting in 1988, on income in excess of \$9,000 a year. The ceiling and the starting point for the phaseout will be indexed for inflation. These changes boost the amount of income a family of four can receive before having to pay personal income tax from \$9,574 in 1986 to \$14,480 in 1988.

*Henry J. Aaron is a senior fellow in the Economic Studies program at Brookings and a professor of economics at the University of Maryland. Aaron is a co-author with Harvey Galper of *Assessing Tax Reform* (1985) and is currently editing a volume analyzing the tax reform law of 1986 and the reforms that still need to be made.*

Table 1.
Changes in Taxes Under 1986 Reform for All Taxpayers †

Gross Income Bracket	Marginal Tax Rates			Total Personal Taxes			Total Returns (thousands)
	Reduced	Unchanged*	Increased	Reduced	Unchanged*	Increased	
Under \$10,000	17.2%	55.2%	27.6%	46.8%	50.4%	2.9%	29,468
\$10,000–19,999	57.3	11.5	31.2	72.9	15.2	11.9	24,718
\$20,000–39,999	81.8	1.9	16.3	70.7	15.2	14.1	30,230
\$40,000–49,999	54.6	1.7	43.8	73.4	17.5	9.1	9,022
\$50,000 and over	87.2	0.7	12.1	60.2	21.7	18.1	14,434
All Taxpayers	57.0	18.5	24.6	63.5	25.9	10.7	107,872

Table 2.
Changes in Marginal Tax Rates by Number of Earners †

Gross Income Bracket	One Earner or None				Two Earners			
	Reduced	Unchanged*	Increased	Total Returns (thousands)	Reduced	Unchanged*	Increased	Total Returns (thousands)
Under \$10,000	17.1%	54.9%	28.1%	28,971	25.0%	71.8%	3.2%	496
\$10,000–19,999	60.7	12.0	27.3	22,559	21.7	6.3	72.0	2,159
\$20,000–39,999	77.5	2.6	19.9	20,891	91.3	0.4	8.3	9,340
\$40,000–49,999	64.9	3.4	31.6	4,336	45.0	0	55.0	4,686
\$50,000 and over	87.8	1.3	10.8	6,369	86.8	0.2	13.0	8,064
Total	52.0	23.3	24.7	83,126	73.7	2.2	24.1	24,745

Table 3.
Changes in Marginal Tax Rates for Itemizers and Non-Itemizers †

Gross Income Bracket	Itemizers				Non-Itemizers			
	Reduced	Unchanged*	Increased	Total Returns (thousands)	Reduced	Unchanged*	Increased	Total Returns (thousands)
Under \$10,000	40.5%	37.7%	21.6%	1,455	16.0%	56.1%	28.0%	28,013
\$10,000–19,999	42.4	15.5	42.2	3,069	59.4	10.9	29.7	21,648
\$20,000–39,999	79.3	3.3	17.5	12,295	83.5	1.0	15.5	17,935
\$40,000–49,999	55.6	2.0	42.4	6,357	52.2	0.9	46.9	2,665
\$50,000 and over	86.9	0.7	12.4	12,600	89.5	0.7	9.7	1,834
Total	73.0	4.6	22.4	35,776	49.0	25.4	25.6	72,095

†Based on projected levels of income in 1988; figures are rounded.

*Includes change in taxes of less than 5 percent or less than \$50.

Source: Brookings tax model developed by senior research programmer Chuck Byce.

— The nominal personal tax rate schedule that ran from 11 percent to 50 percent is replaced by two rates: 15 percent, applicable to taxable incomes of \$17,850 or less for single persons and \$29,750 or less for joint filers, and 28 percent. For a four-person family claiming the standard deduction, the 28 percent bracket applies in 1988 to incomes over \$42,550 (\$29,750 plus \$7,800 in personal exemptions and \$5,000 in standard deductions). The top effective rate is not 28 percent but 33 percent because a number of advantages accorded to low-income taxpayers are recaptured from high-income taxpayers. These advantages include the taxation of some income at 15 percent and the privilege of taking personal exemptions. The maximum corporate income tax rate drops from 46 percent on profits over \$100,000 to 34 percent on profits over \$75,000.

— The tax base is broadened, most notably by provisions that reduce incentives for tax shelter investments and by the repeal of numerous special business deductions. The result is that both individual and corporate income tax rates can be cut with no loss of revenue.

— Discrepancies among tax rates on various types of investment are reduced by repeal of the investment tax credit, revision of depreciation deductions, and a variety of other provisions.

— The exclusion from taxation of 60 percent of long-term capital gains has been repealed, thereby reducing incentives to convert fully taxable ordinary income into long-term capital gains.

What Was Accomplished?

The achievements of the Tax Reform Act of 1986 are significant in several important respects. First, the act reduces marginal tax rates for most taxpayers. Not all groups are equally affected. Of households with incomes below \$20,000 a year, nearly 30 percent will face higher marginal rates, but the increased personal exemptions and standard deductions assure that fewer than 10 percent will actually pay more tax (see table 1).

Marginal tax rates will be reduced for nearly 90 percent of households with incomes of \$50,000 a year or more, but because these taxpayers are hit hard by base-broadening reforms, only three in five of those households will pay less tax. Taxable units with two earners are more likely than units with one earner or none to experience reduced marginal tax rates because two-earner households tend to have high incomes (see table 2). The same reason explains why marginal rates are likely to go down more for taxable units that itemize their deductions than for units that take the standard deduction (see table 3).

Because most people will be able to keep more of each additional dollar that they can earn from work, labor supply is likely to increase. Because not all marginal rates go down and most changes are small, the effect on labor supply will not be dramatic — a 1 percent increase in hours, according to estimates made by Jerry Hausman and James Poterba.¹ But that would be enough to increase productive capacity about \$35 billion a year in 1986 prices.

Second, the 1986 act restores to the tax system some of the progressivity lost through inflation and recent legislation. The increases in the personal exemption and the standard deduction and the liberalization of the earned income tax credit directly remove approximately six million

*“... the Tax Reform Act of 1986
stands as the
most important improvement
in the broad-based taxes
on individual
and corporate income
in at least two decades.
It deals in a fundamental way
with many parts of the
tax code that created
widespread opportunities
to avoid taxation
and distorted
the flow of investment
into wasteful uses.”*

low-income taxpayers from the tax rolls. These provisions are responsible for the large percentage reductions in tax liabilities of taxpayers with income of less than \$20,000.

Congressional staff estimates indicate that all income classes enjoy cuts in *personal* income taxes, reflecting the shift of approximately \$24 billion in taxes each year from individuals to corporations. But the increased corporate income taxes also impose burdens on the people who own capital by reducing their after-tax return on assets. If one takes account of these burdens, not all income brackets gain because the plan is revenue neutral (see table 4). The resulting pattern is clearly progressive, with taxpayers in income brackets below \$50,000 a year enjoying reductions and taxpayers in income brackets above \$50,000 a year bearing increases.

The third major accomplishment will be an increase in the efficiency of investment. Prereform tax law favored certain kinds of investments over others in two ways. First, it imposed highly unequal rates of tax on different assets and industries, which favored lightly taxed but low productivity investment over heavily taxed investment that might be more productive. This distortion hindered growth in output. Second, the prereform law contained a variety of provisions that made "tax shelters" possible. Shelters worked especially well for investments in assets such as commercial real estate, multifamily housing, airplanes, and railroad cars that are good collateral for loans and that can be traded with low transaction costs.

The tax reform act takes large steps to reduce these distortions. The repeal of the investment tax credit and revisions in depreciation schedules narrow the range of effective corporate income tax rates on various assets and industries (see table 5). And the new law erects formidable roadblocks to tax shelters; in addition to repealing the investment tax credit and stretching out depreciation deductions on structures, the reform law curtails deductibility of investment interest, limits the deductibility of losses on passive investments (defined as all real estate investments

Table 4.
Estimated Change in Tax Burdens
in 1988 by Income Brackets

Income Class	Change in Personal Income and Corporate Income Tax Burdens	Change in Total Federal Tax Burdens
Under \$10,000	-32.0%	-12.5%
\$10,000-20,000	-8.1	-3.1
\$20,000-30,000	-4.1	-1.8
\$30,000-40,000	-4.1	-2.0
\$40,000-50,000	-6.1	-3.1
\$50,000-70,000	+0.7	+0.4
\$70,000-100,000	+5.3	+3.9
\$100,000-200,000	+6.0	+5.0
\$200,000 and above	+9.2	+8.2

Source: Author's estimates.

Table 5.
Effective Tax Rates by Asset Type and Industry

	Prereform law	Tax Reform Act of 1986
Asset Type		
Equipment	11%	38%
Structures	35	39
Inventory	58	48
Industry:		
Agriculture	41	42
Mining	30	38
Oil Extraction	23	28
Construction	28	41
Manufacturing	43	43
Transportation	23	37
Communications	24	36
Electric/Gas	28	38
Trade	47	44
Services	32	40
Average	38	41

Source: Jane G. Gravelle, "Effective Corporate Tax Rates in the Major Tax Revision Plans: A Comparison of the House, Senate, and Conference Committee Versions," Congressional Research Service Report 86-854 E, August 26, 1986, table 2.

and other projects the investor does not actively manage), and strengthens the minimum tax to ensure that most taxpayers will pay some tax.

The tax reform law also repeals the exclusion of 60 percent of long-term capital gains. Congress has taxed only a portion of such gains because it feared that realization of large gains could subject individuals to high marginal rates in the year of realization and, in recent years, because part of many capital gains has been the illusory result of inflation. Congress also hoped that low tax rates on long-term capital gains would promote greater entrepreneurial daring.

While congressional intentions were well-meaning, the capital gains exclusion was inefficient and produced serious side effects. Repeal of the exclusion will reduce incentives to invest in assets that have low pretax rates of return but that lend themselves to converting ordinary income into capital gains. A standard ploy, for example, has been to borrow to buy an asset, then use deductions allowed for the interest paid on the borrowed money to offset fully taxable income, and ultimately sell the asset for a gain, 60 percent of which would be untaxed. Under prior law, a taxpayer in the 50 percent bracket who paid \$100 in deductible interest and realized \$100 in long-term capital gains would enjoy a gain of \$30.² Furthermore, the new rate structure weakens the case for retaining the exclusion.

Finally, the tax reform law simplifies the personal income tax for most taxpayers. Some of the six million taxpayers removed from the rolls because of lower rates will

not even have to file. An additional six million taxpayers will no longer need to itemize deductions. Even more important than the simplification in filling out one's return is the simplification that occurs because numerous provisions discourage tax-motivated investments and because the reduction of marginal tax rates curtails the importance of tax considerations on all transactions. Unfortunately these gains in simplicity are offset to a considerable degree by new provisions that add to the complexity for a minority of taxpayers, as explained below.

What Harm Was Done?

The most serious charge brought against the Tax Reform Act of 1986 is that it will increase the effective rate of tax on investment. There is something to this criticism but much less than the average increase of corporate income taxes of \$24 billion a year during the period 1987 through 1991 would suggest (see table 6).

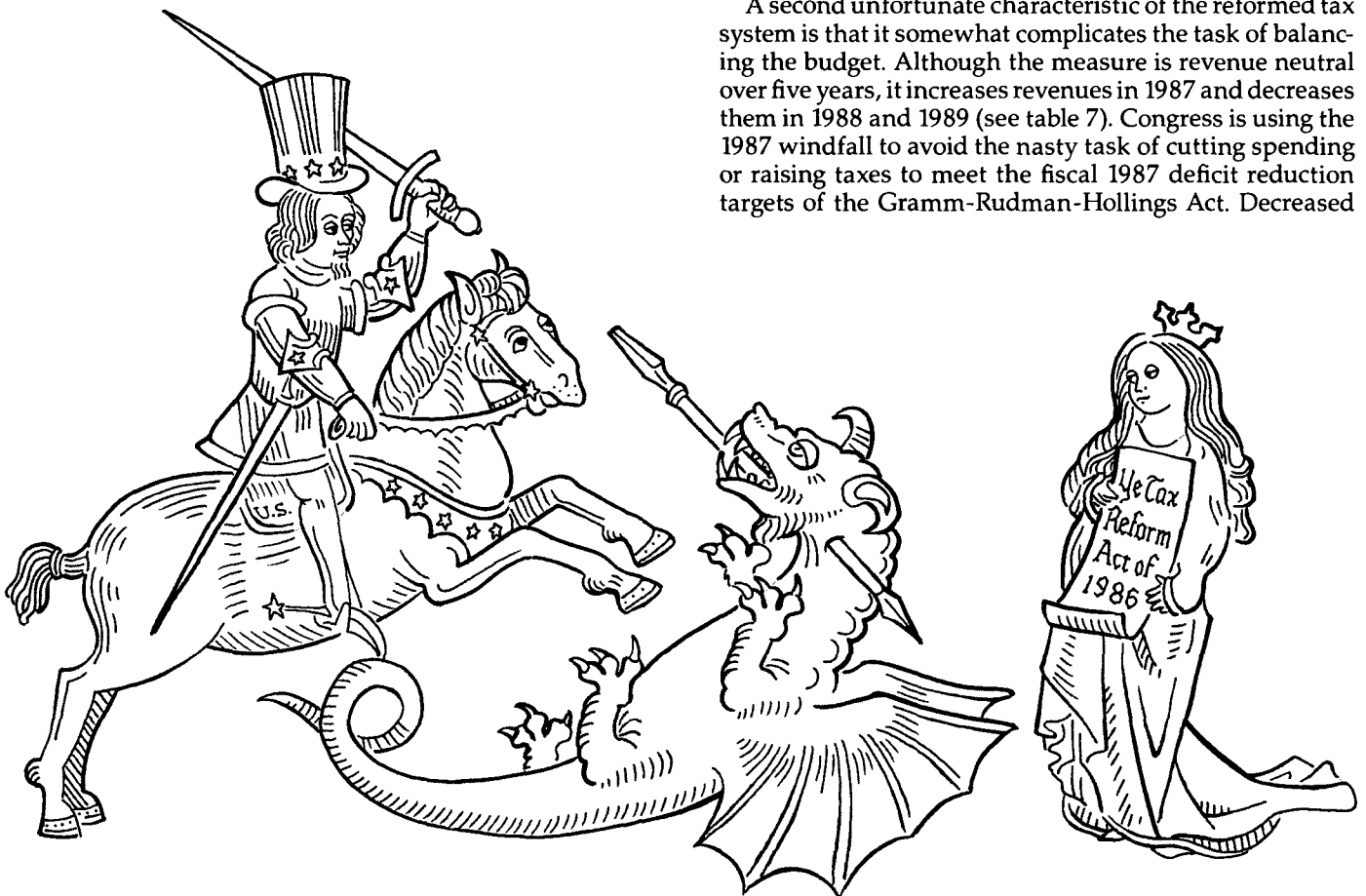
About half of this increase consists of tax changes that will not affect marginal investment decisions in most American industries. Other changes reduce deductions that do not enter into calculations of the profitability of a particular project — for example, limits on deductions for meals and entertainment. Still others increase taxes on investments abroad and may add to investment demand here — for example, some restrictions on the foreign tax credit.

Another set of changes withdraws or reduces extreme advantages to particular industries — taxes, for example, are increased on currently highly favored industries such as defense contractors, petroleum extraction, other mining, finance, and insurance. In addition, relatively few companies will be exposed to the minimum tax. These added tax liabilities will reduce corporate "cash flow" (the sum of after-tax earnings and depreciation reserves), a depressing influence on investment as a whole, but will not change most investment incentives at the margin.

For most companies, the increase in the effective rate of tax on investment from 38 percent to 41 percent, an 8 percent increase in effective rates, will be small.³ This increase results from the repeal of the investment tax credit and amended depreciation deductions offset by lower corporate income tax rates. The 8 percent increase in *effective tax rates* contrasts with the 23 percent increase in *total collections* from all corporate taxpayers. The difference represents acceleration to 1987–91 of some tax payments that would not have been made until after 1991 under old law and some tax changes that affect cash flow.

However measured, the higher cost of capital to corporations will reduce incentives to invest. But this effect will be offset by the increased efficiency in the use of capital. Furthermore, monetary or fiscal policies that reduced interest rates by 0.8 percentage points would fully offset the increase in the cost of capital caused by revision of the corporate income tax.⁴

A second unfortunate characteristic of the reformed tax system is that it somewhat complicates the task of balancing the budget. Although the measure is revenue neutral over five years, it increases revenues in 1987 and decreases them in 1988 and 1989 (see table 7). Congress is using the 1987 windfall to avoid the nasty task of cutting spending or raising taxes to meet the fiscal 1987 deficit reduction targets of the Gramm-Rudman-Hollings Act. Decreased



revenues in the following two years, however, will make continued reduction of the federal deficit even more difficult than it has been so far.

Although the Tax Reform Act of 1986 may hinder deficit cuts in the short run, it could facilitate the eventual elimination of the budget deficit. By improving the fairness and reducing the distortions *without sacrificing revenues*, the tax reform act may make it easier for Congress to raise taxes as part of a deficit reduction package.⁵

A final negative aspect of the new bill is that a minority of taxpayers will face a more complex tax system than they currently do. The expanded minimum tax is a set of provisions of labyrinthine obscurity. Various rules for recapturing at high incomes tax advantages permitted on low incomes add to the complexity for the small fraction of taxpayers to which they apply. These include the phaseout procedures that withdraw from high-income taxpayers the advantage of the 15 percent bracket, personal exemptions, deductions for contributions to individual retirement accounts, and deductions for up to \$25,000 of losses on passive investments.

Much of this complexity results from the refusal of both the president and Congress to deal with fundamental inconsistencies that remain in the tax code. The phaseout rules permit Congress to maintain the fiction that the top marginal individual income tax rate is 28 percent. In fact, as noted earlier, it rises to 33 percent over the income range in which the phaseouts of the personal exemptions and 15 percent bracket occur.⁶ And because Congress permitted

some opportunities for tax avoidance to remain in the tax code, it was compelled to retain a minimum tax. The Treasury Department's proposal of November 1984 would have done away with the need for a minimum tax by eliminating the major devices for avoiding taxes that the old and revised minimum taxes are designed to curb.

What Opportunities Were Missed?

The president and Congress missed three big opportunities for reform.

First, they wasted an ideal chance to enact automatic adjustments to prevent inflation from distorting the measurement of capital income. Congress retained indexation of exemptions, the standard deduction, and tax brackets, first enacted in 1981, but did not adopt the Treasury Department proposal to index depreciation, interest payments and income, capital gains, and inventory costs. The absence of an automatic adjustment mechanism during the inflation of the late 1970s and early 1980s led Congress in 1978 to increase the proportion of long-term capital gains excluded from tax and in 1981 to enact a number of ad hoc provisions — notably depreciation deductions more favorable to some assets than to others — that contributed to the wide variations in effective tax rates among different types of assets. The Treasury Department's 1984 proposals would have removed the need for such adjustments during any future inflationary episode.

Unfortunately, the president rejected some of Treasury's

Table 6.
Estimated Revenue Changes in Corporate Income Tax, 1987–1991

	Increase (in billions)
Changes in specific items	
1. Limitation on deductions for meals, travel, and entertainment	\$ 6.2
2. Repeal of sales-tax deduction	1.3
3. Dividend received deduction, other dividend changes, and change in liquidation rules	3.0
4. Compliance and tax administration	2.1
5. Financial institutions	8.3
6. Foreign tax provisions	9.3
7. Pensions and employee stock option plans	2.5
8. Insurance products and companies	11.5
9. Accounting provisions	21.5*
10. Intangible drilling and other mining costs except minimum tax	0.6
<i>Subtotal</i>	<i>66.3</i>
Minimum tax	22.2
<i>Total</i>	<i>88.5</i>
Changes other than listed items	31.8
Overall changes in corporate income tax	\$120.3

*Includes \$7.5 billion for repeal of reserves for bad debts of nonfinancial corporations; \$9.6 billion on long-term contracts; \$0.1 for qualified discount coupons; \$1.5 billion for requiring utilities to accrue earned but unbilled income, and \$2.8 billion for limits on use of cash accounting. Excludes \$7.3 billion for recognition of gain on pledges of installment obligations; \$32.2 billion for capitalization of inventory, construction, and development costs; \$0.5 billion for contributions in aid of construction; and \$0.3 billion for discharge of indebtedness.

Source: Tax Reform Act of 1986, H. Rept. 99–841, vol. 2, 99 Cong. 2 sess. (GPO, 1986), table A.2, pp. II–866–84.

Table 7.
Estimated Effect of Tax Reform
on Federal Revenues

Fiscal Year	Revenues (billions of dollars)
1987	\$ 11.4
1988	-16.7
1989	-15.1
1990	8.1
1991	12.0
1987-1991	-0.3

Source: Tax Reform Act of 1986, H. Rept. 99-841, vol. 2, 99 Cong. 2 sess. (GPO, 1986), p. II-884.

recommendations, and Congress abandoned the rest. The fact that none was enacted demonstrates that indexation of the income tax base has little political sex appeal when inflation is low. However, if inflation reemerges, Congress will be pressured once again to enact ad hoc adjustments, which will leave a residue of distortion. The lesson that inflation can undermine a tax system has not yet been learned.

The president and Congress also failed to make any progress in two other areas that would have advanced equitable and efficient income taxation: the taxation of fringe benefits and the integration of the personal and corporate income taxes. The Tax Reform Act of 1986 does little to bring into the tax base fringe benefits that provide current consumption services to employees. Such fringes include employer-financed health insurance, up to \$50,000 a year of term life insurance, group legal insurance, and assorted other items.

President Reagan in 1982 proposed limits on the exclusion from personal income tax of employer-purchased health insurance. He would have retained exclusion only up to a level sufficient to finance a fundamental health insurance plan; the cost of additional insurance was to be taxed as current income to employees. The Treasury incorporated this recommendation, along with other limits on the exclusion of fringe benefits, in its 1984 proposal. Faced with the unbending opposition of Senator Bob Packwood, chairman of the Senate Finance Committee, the president backed down and replaced the Treasury initiative with a watered-down proposal that had no appeal. The Committee on Ways and Means of the House of Representatives killed the president's proposal and rejected all alternative devices for including consumption-type fringe benefits in taxable income.

While little was done to limit exclusion of fringe benefits, Congress included a variety of amendments to tighten existing rules designed to prevent such fringes from primarily serving high-income employees. These "nondiscrimination" rules typically require that no more than a stipulated fraction of a particular type of benefit can accrue to high-wage workers.

This outcome means that the tax system continues to favor certain kinds of consumption over others. Most notably, the tax system continues to encourage employees to

*"Although the [tax reform] may
hinder deficit*

cuts in the short run,

it could facilitate

*the eventual elimination of the
budget deficit.*

*By improving the fairness
and reducing the distortions
without sacrificing*

*revenues, the tax reform act
may make it easier*

for Congress to

*raise taxes as part of a
deficit reduction package."*

seek and employers to provide health insurance plans that promote medical cost inflation by providing elaborate benefits that require patients to bear only a small portion of the costs. It means that additional cuts in tax rates that would have been possible if fringe benefits had been included in the tax base had to be forgone. But it also means that such fringe benefits will be available more equally than in the past to low- and middle-wage workers.

The final missed opportunity was the failure to reduce the double taxation of dividend income. Under current law, dividend recipients are taxed twice — once indirectly by the corporate income tax, and once directly by the personal income tax. Most developed nations have instituted some relief for this double taxation.⁷ The Treasury Department in 1984 proposed to permit corporations to deduct 50 percent of dividends paid. The White House scaled this deduction back to 10 percent phased in over 10 years. The House dropped the deduction altogether, and the Senate did not revive it.

The dividend deduction would have encouraged corporate managers to pay out a larger proportion of earnings in dividends. This incentive may explain its demise. If dividend payments increased, corporate managers would retain a smaller pool of earnings for new investment projects. They would have to rely to a greater extent than they now do on new issues of debt and equity to raise funds. Open market competition for investment funds might increase the efficiency with which those funds are allocated, but it would assuredly complicate the fund-raising tasks of corporate managers. The current tax policy of discouraging dividend payment lessens this particular managerial headache. The lack of enthusiasm among corporate managers for a dividend deduction, which made it easy for the White House and Congress to jettison the proposal, probably owes something to this fact of corporate financial life.

What Will Be the Economic Effects?

The effects of the tax bill on overall economic performance are likely to be small. The shift in taxes from individuals to corporations will cause an increase in personal disposable income. Because consumption is closely tied to personal disposable income, consumption outlays may go up in 1987 and beyond. Because deductions for state and local sales taxes will be repealed as of January 1, 1987, the bill may also cause some increase in purchases of costly consumer durable goods during the last quarter of 1986.

The overall effects on investment are difficult to gauge because many offsetting factors are at work. On one hand, the increase in corporate income taxes will reduce corporate cash flow, a development that, as noted, will discourage corporate investment. The increase in the effective tax rate on investment will also tend to reduce investment.

On the other hand, the same increase in effective tax rates will increase the tendency for the value of the U.S. dollar to fall, a development that should make U.S. goods more competitive in international markets. This effect follows because higher taxes will reduce the appeal of U.S. assets relative to foreign assets and thereby reduce the demand for U.S. dollars. Additional decline in the value of the dollar will improve U.S. competitiveness. Whether the dollar's decline will also increase investment depends on what happens to U.S. interest rates.

While the tax reform will have only modest effects on the economy as a whole, it will have important impacts on particular industries and companies. For example, the cost of capital for such "tax shelter" investments as office buildings and multifamily housing will increase. Other industries, such as trade, computers, and some manufacturing, will gain more from lower tax rates and liberalized depreciation on equipment than they will lose from repeal of the investment tax credit and slower depreciation on structures.

Eliminating tax preferences that hampered investment efficiency and the growth of economic capacity was a primary objective of tax reform. But there is no way to correct past imbalances and achieve these gains in efficiency without shifting tax burdens among industries. And when tax incentives, which have contributed to overinvestment in favored activities, are reduced, the adjustments may be difficult and protracted. For example, the vacancy rates for offices, which exceed 20 percent in many cities and which are attributable in part to tax shelters that encouraged construction even when potential occupants could not be identified, will take many years to decline to economically efficient levels.

A Final Appraisal

Although these missed opportunities and the harmful elements of the tax reform should not be ignored — if possible they should be corrected in future legislation — they should not obscure the major achievements in the Tax Reform Act of 1986. By removing millions of poor families from the tax rolls and reducing the burdens of millions of other low-income families, by slashing marginal tax rates and thereby reducing the importance of taxes in economic decisions, by ending the distinction between long-term and short-term capital gains, and reducing the incentives to engage in complex tax-avoidance maneuvers, by curbing tax shelters, and by equalizing effective tax rates on various kinds of investment, the tax bill represents a significant improvement in the structure of personal and corporate income taxes. That a good bill contains flaws, some of them important, may make us yearn for what might have been, but it should not prevent us from celebrating a splendid political and economic achievement.

1. Jerry A. Hausman and James M. Poterba, "Household Behavior and the Tax Reform Act of 1986," *Journal of Economic Perspectives*, forthcoming.

2. The taxpayer paid \$100 in interest but saved \$50 in taxes because the interest is deductible, for a net cost of \$50. The tax liability would be only \$20 on the \$100 capital gain because only \$40 of the gain would be subject to tax; hence the net gain is \$80. The \$80 net capital gain less the \$50 net interest cost equals \$30.

3. Jane G. Gravelle, "Effective Corporate Tax Rates in the Major Tax Revision Plans: A Comparison of the House, Senate, and Conference Committee Versions," Congressional Research Service Report 86-854 E, August 26, 1986, table 2.

4. Estimates reported to the author by Jane G. Gravelle, Congressional Research Service.

5. James M. Buchanan, "Tax Reform and Political Choice," *Journal of Economic Perspectives*, forthcoming.

6. The tax law also contains other phaseouts — of the exclusion of contributions to individual retirement accounts for example — that generate other effective marginal rates.

7. Joseph A. Pechman, "Tax Reform Prospects in Europe and Canada," *The Brookings Review*, vol. 5 (Winter 1987), pp. 11–19.



Tax Reform Prospects in Europe and Canada

Joseph A. Pechman

TAXATION IS USUALLY an important item on the policy agenda of most Western countries, but it is now receiving unusual attention. In part, this increased scrutiny reflects both a general dissatisfaction with the heavy burden of taxation that accompanied the rise in government expenditures during the 1960s and 1970s and a widely held view that tax systems in the Western world are unfair and inefficient. The recent passage of a comprehensive tax reform in the United States has also had a tremendous influence on the thinking of key opinion leaders inside and outside governments about the practicality of tax reform.

I visited six European countries and Canada in the spring and summer of 1986 to learn firsthand what the major tax issues were and the solutions that are being considered. In each country, I had an opportunity to discuss tax policy with government and opposition leaders, tax officials, business executives, and tax experts in the private sector and in the academic community. I was cordially received everywhere, and the discussions were frank, stimulating, and informative. As a result, I believe I was able to identify the key issues and to learn how they are likely to be resolved.

The countries included in this survey are Canada, Sweden, the Netherlands, France, Italy, West Germany, and the United Kingdom. Taxes in each of these countries are higher than in the United States, ranging in 1984 from 33.7 percent of gross domestic product in Canada to 50.5 percent in Sweden. The comparable figure for the United States was 29 percent (see table 1). All seven countries rely much more heavily on payroll and consumption taxes than the United States does. Yet in most of these countries, individual and corporate income tax rates are at least as high as in the United States.

Although the tax structures and major tax problems differ greatly among the seven countries, a number of common themes emerged:

1. Disenchantment with tax incentives for investment is growing throughout the seven countries I surveyed. Each of them has experimented with such incentives, but the tax rates on investment differ greatly. Julian Alworth of the Bank for International Settlements has estimated that, assuming zero inflation, the average effective marginal tax rate on investment in 1985 was -15 percent in Italy, 33 percent in the United Kingdom, 48 percent in France, 60 percent in West Germany, and 74 percent in the Netherlands. Differences in the tax rates applying to different types of assets both within and among countries were also large. Opinion is now widespread that these differences distort the allocation of resources and create numerous inequities among industries and companies. Britain has already replaced immediate expensing of plant and equipment with more realistic depreciation rates and lowered the corporate tax rate. Canada is phasing out its investment tax credit and reducing the corporate tax rate. Now that the United

Joseph A. Pechman is a senior fellow in the Economic Studies program at Brookings. In addition to his work on comparative tax policies, he is preparing a fifth edition of his book Federal Tax Policy and is editing a book on the recently enacted U.S. tax reform. His research on tax developments in other countries is being supported by grants from the German Marshall Fund and the Alfred P. Sloan Foundation. The views expressed here should not be attributed to Brookings or to the two supporting foundations.

States has also eliminated its investment tax credit and lowered its corporate tax rate to 34 percent, other countries are reconsidering the structure and rates of their corporate taxes.

2. Incentives to encourage personal saving through the tax system are also universal. In addition to tax deferral for employer contributions to employee pension plans, the devices include deductions similar to individual retirement accounts for individuals with earned income, exemptions for small amounts of interest and dividends, flat tax rates far below the ordinary tax rates on taxable interest and dividends, deductions for life insurance premiums, and favorable treatment of investments in small business enterprises. Capital gains on financial transactions are either wholly tax-exempt or taxable at preferential rates. Tax officials recognize that these provisions distort the allocation of saving, complicate the income tax, and favor high-income taxpayers. But they are reluctant to curtail these preferences, even if the tax rates are reduced at the same time, because they fear political repercussions.

3. Like the United States, Sweden and the Netherlands levy separate corporate and individual income taxes, so that dividends are in effect taxed twice. The other five countries attempt to integrate the two rates by enacting some form of dividend relief at the individual level. Until recently, Canada and Italy provided such relief even when no corporate tax had been paid on the distributed earnings. To bring the tax on distributed profits up to the statutory level, Italy has adopted an "advance corporate tax" similar to the tax levied in France, Germany, and the United Kingdom. Canada is avoiding the advance corporate tax; instead, it has reduced the dividend tax credit from 50 percent to 33.3 percent.

4. Payroll tax rates are extremely high by U.S. standards. The payroll taxes are needed to finance social security systems that are much more extensive than the U.S. system. Demographics will create difficult financing problems for the retirement systems, but action to solve these problems is being deferred everywhere.

5. The value-added tax (VAT) continues to be a mainstay of the European tax system. In most countries, numerous exemptions and a variety of tax rates complicate administration, but very little is being done to simplify matters. Canada is planning to substitute a value-added tax for its manufacturer's excise tax, making the United States and Japan the only Western economies without a VAT (but Japan is seriously considering the introduction of this tax).

6. Because they are open economies, the six European countries and Canada are extremely sensitive to tax policies in other countries. On the one hand, they are reluctant to eliminate tax preferences for saving and investment for fear that capital will flow abroad. On the other hand, they are impressed with the success of tax reform in the United States, particularly the large reduction in tax rates it provides. Although these governments feel pressure to make their tax systems more equitable and more efficient, it is not clear whether they will in fact have the political will to follow the lead of the United States.

The following summaries of the discussions I had in each country provide more detail on these developments.

Sweden

Sweden has the highest tax burden in the world. Individual income tax rates range from 34 percent to a maximum of 80 percent and the corporate tax rate is 52 percent. Payroll taxes and the VAT are also high by international standards. Sweden is now considering a modest reduction in the top individual income tax rate and upward revisions in the capital gains tax. It is also studying the role of corporate income taxation in its tax system.

Investment and Capital Income. There is considerable diversity of opinion about how to make the Swedish tax system more neutral. Some propose elimination of the individual income tax on capital income entirely, on the ground that the deduction for interest is larger than capital income for top-bracket taxpayers so that the net tax on

Table 1. Tax Revenue as a Percent of Gross Domestic Product in Europe, Canada, and the United States, by Source, 1984

Country	Individual Income	Corporate Income	Payroll	Consumption ^a	Property	Wealth	Total
Sweden	19.4%	1.8%	15.7%	13.1%	0.2%	0.3%	50.5%
Netherlands	9.5	2.6	20.2	12.0	0.8	0.4	45.5
France	6.1	1.9	20.9	15.2	1.1	0.4	45.5
Italy	10.9	4.1	14.0	12.2	^b	0.1	41.2
United Kingdom	10.3	4.4	7.4	12.0	4.2	0.2	38.5
West Germany	10.5	2.0	13.7	10.5	0.4	0.6	37.7
Canada	11.6	3.0	4.3	11.5	3.1	0.2	33.7
United States	10.2	2.1	8.4	5.3	2.7	0.2	29.0

^aIncludes sales, value-added, and excise taxes; import and export taxes; taxes on transfers of property and securities; other transactions paid by enterprises; and miscellaneous other taxes.

^bLess than 0.05 percent.

Source: Organization for Economic Cooperation and Development, *Revenue Statistics of OECD Member Countries, 1965-85* (Paris: OECD, 1986). Figures are rounded.

*"On the one hand, [the six European countries and Canada]
are reluctant to eliminate tax preferences
for saving and investment for fear that capital will
flow abroad. On the other hand, they are impressed with
the success of tax reform in the United States. . . ."*

capital income is negative. Others propose to substitute a consumption expenditure tax or a labor income tax, combined with a more effective tax on wealth, for the general income tax. There is also interest in Sweden in a Danish reform, which taxes net capital income separately from labor income at a flat 50 percent rate (thus limiting the tax value of interest deductions to 50 percent). Such a system would increase taxes on capital income in Sweden.

Home owners also have negative income from their investment. Assessed values to compute the rental value of owner-occupied houses (which is included in taxable income) are substantially below true value, yet full deduction is allowed for mortgage interest. To limit the revenue loss, deficits on capital income can only be deducted at a maximum rate of 50 percent, except that up to Skr 30,000 (about \$4,500) may be deducted at above the 50 percent rate for owner-occupied homes.

Swedish experts generally agree that the deductions for saving encourage people to funnel their savings into tax-exempt forms, such as insurance; there are now 2.7 million tax-exempt savings accounts. But estimating how much this type of saving has been substituted for other forms is impossible. In fact, personal saving as a ratio of GNP has declined sharply.

The Corporate Tax. The classical system of corporate taxation (that is, separate taxation of corporate and individual income) is used in Sweden, and there is no pressure to relieve the so-called "double taxation." The corporate tax is not a big tax (considering the generous allowances for investment), so the double taxation is not large. Moreover, business managers prefer to keep the money at the corporate level for reinvestment purposes and oppose any tax measure that would lower the tax on distributed earnings and thus pressure companies to increase distributions. However, relief is provided for dividends paid on newly issued shares and by unlisted corporations.

Payroll Taxes. Payroll taxes now average 36 percent of

wages and salaries and are used to finance the large income transfer system as well as the public pension system. The public approves the use of payroll taxes in this way, because it would be impossible to impose an additional load onto the individual income tax.

The social security system is on a pay-as-you-go basis, and with moderate reductions in benefits or increases in taxes the system will be self-financing for some years to come. However, the demographics will change radically in the twenty-first century, and some revisions in the underlying financing system will have to be made. Because other matters are more urgent, no changes are expected in the years immediately ahead.

Tax Reform. The government has just completed a tax revision program that will reduce individual income tax rates to a maximum of 75 percent. Movement in other areas will be slow because the government does not want to jeopardize economic expansion. However, everyone agrees that the current tax treatment of capital income is *not* viable for the long run, and an upward revision of the capital gains tax is next on the agenda. An official committee studying the corporate tax will report in 1987, so a revision of that tax cannot be expected until 1988. A separate committee is studying the expenditure tax. Tax experts in the Ministry of Finance would like to broaden the income tax base and lower rates, but nothing has yet been decided, partly because of political considerations.

The Netherlands

Individual income tax rates in the Netherlands range from 16 percent to 72 percent, but numerous tax preferences reduce effective rates—especially for recipients of investment income. The government is now preoccupied with a proposed simplification of its individual income and payroll tax systems, but little consideration is being given to broadening the income tax bases.

Investment and Capital Income. Capital income is very lightly taxed in the Netherlands because (a) the corporate tax is low, (b) capital gains on the sales of securities are exempt from tax, (c) houses are assessed at 60 percent of market value for purposes of calculating the rental value of owner-occupied homes, while mortgage interest is fully deductible, (d) small deductions are allowed for interest and dividends and a large deduction for insurance premiums, (e) all other interest is fully deductible, and (f) the wealth tax plus income tax is limited to 80 percent of taxable income, no matter how low taxable incomes may have been driven by the deductions for interest and insurance premiums. Although the tax on capital is low (or perhaps even negative), nobody has taken the trouble to calculate the net tax burden on capital income.

Some people in the Netherlands believe that capital gains should be taxed and that a limit should be placed on the deduction for interest expense. However, they are in the distinct minority. Tax officials and private tax experts alike do not agree that limits can be placed on capital loss and interest deductions, partly because they are worried about a flight of capital abroad. Even the Social Democrats do not urge taxation of capital gains.

Officially, depreciation is calculated according to "conventional accounting standards." In practice, it is negotiated between the tax inspector and the business. Depreciation allowances seem to be more generous than economic depreciation, in conformity with court decisions that have tended to give considerable weight to the inadequacy of historical depreciation during periods of inflation. In addition to depreciation, the Dutch tax system gives an investment tax credit of 12.5 percent on buildings as well as machinery.

The Dutch recognize the considerable nonuniformity with which they treat different assets and industries and the many distortions in investment patterns that result. I found no one in the Netherlands who was concerned about these distortions.

The Corporate Tax. The Dutch use the classical corporate tax system because several very large multinational corporations are based in Holland and it is an open economy. The government would prefer to avoid the problems of how to restrict dividend credits to domestic shareholders and how to impose an advance corporate tax in cases where the corporation has been paying no tax. (The latter is a substantial possibility because many of the multinational companies could use the Dutch Antilles as tax havens.)

Tax Reform. A prestigious tax reform commission issued a major report at the end of May 1986, which dealt primarily with simplification of the complicated income tax and social security tax system. The commission proposed integration of income and social security taxes at a flat rate of 40 percent on a wide first bracket, after which progression would rise to 65 or 70 percent. The 40 percent rate would apply to 88 percent of the taxpayers. This revision would enable the tax authorities to dispense with tax returns for many taxpayers with income subject to withholding, probably two to three million out of the seven million total.

The commission did not make any proposals to broaden the tax base, although some of its members believe that the Dutch should follow the U.S. example. However, political leaders and tax officials are hesitant about going in this direction on the usual grounds (such a reform will "hurt" too many important taxpayer groups; transition problems

*"The Dutch recognize the considerable nonuniformity
with which they treat different assets and industries
and the many distortions in investment
patterns that result. I found no one in the
Netherlands who was concerned about these distortions."*

are difficult; the public will not accept reforms that deny them cherished tax advantages, and so on). Moreover, because public expenditures are high, most observers believe that rates cannot be brought down very far even with substantial base-broadening.

France

The French have relatively high individual income tax rates (the maximum rate is 65 percent), but they collect only a small amount of revenue from the income tax because numerous deductions and tax credits erode the tax base. The Chirac government has already eliminated the wealth tax and expects to reduce the top income tax rate to 50 percent. However, significant reform of the income taxes is not in the offing. In fact, the government has been adding new tax preferences, rather than curtailing them. As a consequence, the VAT and payroll taxes account for most of the revenue.

Investment and Capital Income. The French are familiar with the calculations made in the United States and the United Kingdom of the effective tax rates on capital but have not made such calculations for themselves. They know that their business tax system is not neutral among assets and industries but do not seem to mind it. As one expert put it, "the French tax system is not neutral *by design*."

Capital income is taxed lightly in France, if at all. Capital gains are subject to a flat rate of 16 percent; contributions to pension plans are deductible without limit; modest deductions are allowed for life insurance premiums and mortgage interest; and favorable treatment is accorded to investments in risk capital investment funds. However, none of the political parties proposes any significant reforms in this area.

The Corporate Tax. Under the integrated tax system, the French provide a credit for part of the corporate tax on dividends through an "imputation" system. Under this system, the shareholder is given a credit (*avoir fiscal*) calculated at 50 percent of dividends received. This credit was equivalent to one-half of the corporate tax rate until recently when the rate was reduced to 45 percent. If the profits distributed as dividends do not bear the full corporate tax, the corporation must pay an equalization tax (*precompte*) to bring the tax on distributed profits up to that level. The dividend credit was not changed when the corporate rate was reduced to 45 percent, which means that the effective dividend relief was raised from 50 percent of the corporate tax to 61 percent. The imputation system seems to be popular with all groups. The Chirac government would support further increases in dividend relief if it were not for the budgetary constraint.

Payroll Taxes. Payroll taxes, which equaled 58 percent of the average manufacturing wage in 1984, are heavy in France because they are easy to collect and invisible to the average citizen. The high payroll taxes and tax incentives for investment may have encouraged companies to substitute capital for labor, which is particularly disturbing in an economy where unemployment remains high. However, no other source of revenue is readily available to finance the French social security system.

Tax Reform. The Chirac government has announced its intention to reduce the top-bracket individual income tax rate to 58 percent in 1986 and to 50 percent by 1989. It has also said that it will cut the corporate tax rate to 42 percent

by 1988. But it has not proposed any other major changes in the tax structure. A reform of the *tax professionnelle* (a local payroll tax) is expected but not much more. The U.S. experience with tax reform will have some influence on professional opinion in France, but nobody expects any significant effect on French tax policy. In fact, some tax experts fear a new wave of tax expenditures, as the new government attempts to appeal to major political groups — farmers, small businesses, and low-income groups, for example. The French seem to be quite happy with their tax system.

Italy

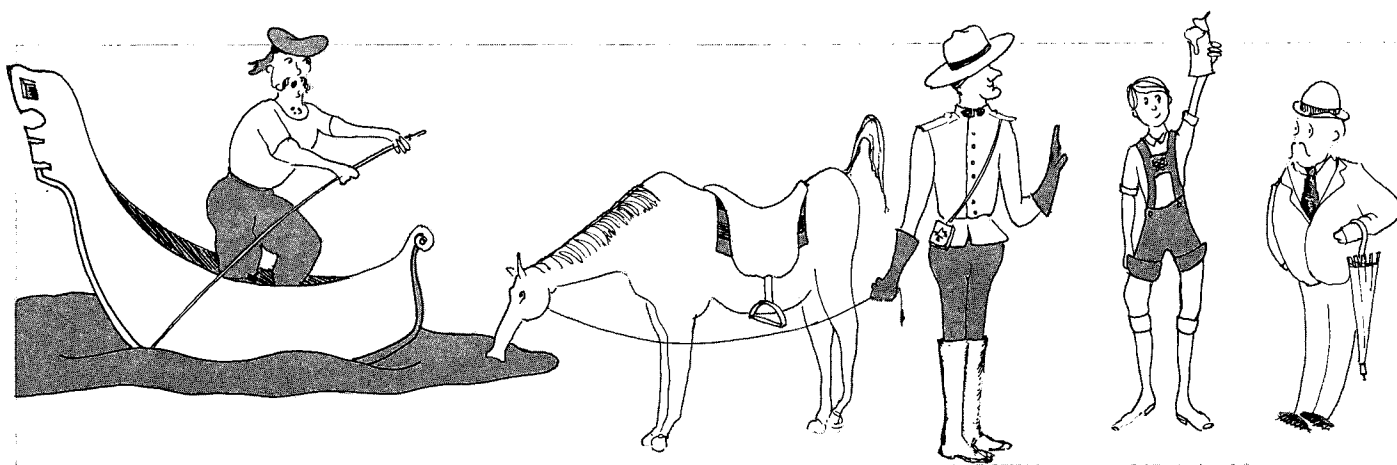
Italy is noted for the high degree of noncompliance of its citizens with its major taxes. In addition, numerous special deductions and tax credits have narrowed the tax bases of both the corporate and individual income taxes. Even though the "primary deficit" — that is, the deficit *excluding* interest payments on the debt — exceeds 5 percent of GNP, significant tax reforms do not seem to be in the offing because the coalition government is too weak to overcome the political obstacles to tax reform.

Investment and Capital Income. Italian officials are aware that their tax system is unnecessarily complicated and distorts the allocation of investment. (Italy has a system of grants to industry for investment in the south, as well as accelerated depreciation.) Italian academics and tax officials were not surprised to learn that the average marginal tax on investment in Italy is negative. They also agreed that the tax distortions in their system must be very large, but no one seemed disturbed about them. Italians *like* to use tax devices to promote economic objectives, even if they generate distortions.

The Italian tax system provides several types of preferences for saving: (a) interest on government bonds is taxable to individuals at a low flat rate (12.5 percent beginning in 1987); (b) nondividend income from financial assets is subject to a variety of flat withholding rates, all of them much lower than the top-bracket rates (for example, the withholding rate for interest on private bonds is 12.5 percent); and (c) capital gains on financial securities are tax-exempt. The Italian saving rate has been very high for years, but there is no way to determine whether the tax system has been a major factor. Everybody, including the minister of finance, recognizes that something should be done about this hodgepodge. But the government is restrained by the fear of antagonizing important pressure groups.

The Corporate Tax. Italy provides a full tax credit for the corporate tax at the individual level. Prior to 1983, this credit was allowed whether or not taxes were actually paid by the corporation. To remedy this defect, a "balancing tax" was levied at the corporate level to require tax payments when dividends are paid out of tax preferences. This operates like the *precompte* tax in France and advance corporate tax in the United Kingdom. There is no evidence of any dissatisfaction with this system now that the balancing tax is in place.

Payroll Taxes. Italian payroll taxes ranged from 48 percent in the handicrafts to 56 percent in industry in 1985. Italy relies on these taxes to pay for its social security system, which provides a wide range of benefits for retire-



ment, disability, unemployment compensation, family allowances, and health. The tax subsidy to capital and the heavy tax on labor income may reduce the demand for labor, but nobody has tried to measure this effect.

Italians in and out of government recognize that their social security system is too generous, but very little is being done about it. Health benefits will probably be limited to restrain the growth in health expenditures and to encourage economy in the use of health services. The retirement system is run on a pay-as-you-go basis, and demographic shifts will soon require action to keep the system solvent. Because they are already high, payroll taxes are not likely to be increased. But the government is not facing up to the inevitability of reductions in retirement benefits.

Tax Reform. Because the coalition government is weak, a frontal assault on tax preferences to achieve equity and reduce distortions is not in the cards. On a vote of no-confidence in the Craxi coalition, the parliament last June turned down a long-overdue reform of the local tax system. Tax experts in the government and the universities admire the U.S. tax reform, but they do not believe it can be duplicated in Italy.

West Germany

West Germany is reducing its marginal income tax rates, but is retaining the top-bracket rate of 56 percent. Despite numerous features that erode the tax bases, very little attention is being paid to improving the equity and efficiency of the individual and corporate income taxes.

Investment and Capital Income. It is generally understood that major distortions in the economy are a result of the special tax concessions and preferences for investment. The interest deduction is also a major problem, just as it is in the United States. The West German government and most academics believe that the distortions should be reduced by eliminating the tax preferences and reducing the tax rates. Despite the tax breaks, the average marginal tax rate on income from new investment is higher in Germany than in most other countries — a fact most Germans are unaware of. (As noted above, Alworth has estimated that the effective marginal tax rate on investment in Germany was 60 percent in 1985.)

Provisions in the tax law intended to promote saving include special deductions for life insurance and saving for housing, a small deduction for "capital-forming pay-

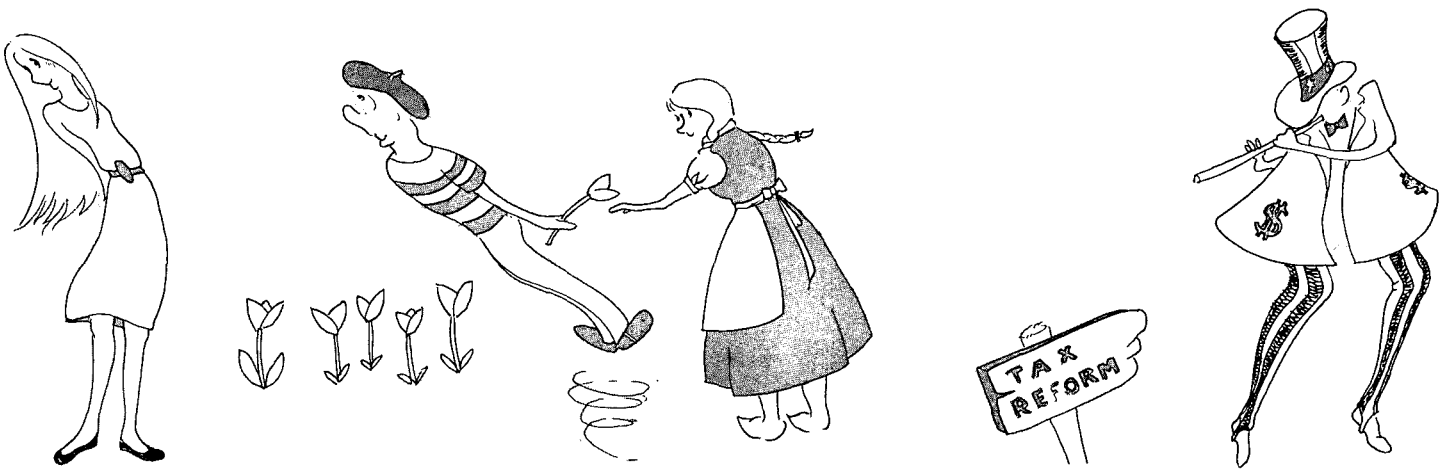
ments" to employees, a bonus for the construction of a dwelling, and complete exemption of capital gains on securities. Saving by German households is high, but whether the tax preferences have been a major factor in promoting such saving is unproved. Most experts believe that the saving incentives should be eliminated (except for the capital gains preference). But there is no political will to change the status quo.

The Corporate Tax. The present split-rate tax on corporate profits was adopted in 1977 after thorough discussion. Retained profits are taxed at 56 percent and distributed profits at 36 percent. The shareholder is granted a tax credit against his individual income tax for the 36 percent paid at the corporate level. A wide political consensus developed to tax distributed profits less heavily than retained profits, partly for equity reasons and partly to promote a wider distribution of corporate shares. Relief was given at the individual level to avoid giving tax benefits to foreigners, who hold about 45 percent of the stock of German corporations. There is no evidence that dividend relief has increased the number of shareholders or the amount of equity financing by shareholders.

Payroll Taxes. The payroll tax on wages of the average employee is about 31 percent, half of which is paid by the employer and half by the employee. Although this rate is lower than in most other European countries, the Germans recognize that it is high, discouraging the use of labor and encouraging workers to work in the hidden economy. Politicians and fiscal experts agree that these rates should come down, but payroll taxes cannot be reduced unless social security benefits are cut.

Tax Reform. The second stage of the tax cut enacted in 1985 is set to go into effect on January 1, 1988, when marginal tax rates will be reduced by up to 5.5 percentage points (and by another 0.5 percentage points for each child). Beyond this change, the government has said it intends to move toward a "linear" rate of progression to flatten the tax rates in the middle income brackets that rose sharply in the 1970s as a result of bracket creep.

Like other Europeans, the Germans recognize that their investment and savings incentives create distortions but fear that heavier taxation will encourage capital flight. Hence, they are reluctant to eliminate these preferences even though they realize they could then lower marginal tax rates. The Social Democrats are in favor of removing preferences and taxing capital gains, but they are not very vigorous in their support for drastic changes in the tax law.



A major difficulty with tightening the preferences for savings occurs because financial institutions are not required to report investment income to the government. As a result, a great deal of taxable interest income is unreported. But because the Germans are so opposed to disclosing personal information to the government, it seems unlikely that anything will be done about this problem.

The radical tax reform in the United States is widely discussed in Germany. Government officials and tax experts are impressed but voice considerable skepticism about the political feasibility of adopting such an approach in Germany.

The United Kingdom

The United Kingdom led the United States by two years in curtailing tax incentives for investment and reducing the corporate tax rate. Yet, it displays little interest in improving the bases of the income taxes in other respects. In fact, it has recently added a number of tax expenditures and has proposed a tax subsidy for private profit-sharing plans to encourage more flexible wage and hiring practices.

Investment and Capital Income. Two years ago, the conservative government phased out expensing of plant and equipment expenditures and used the revenue to reduce the corporate income tax rate to 35 percent. The two-year transition period ended on April 30, 1986. Curiously, there was very little opposition from the business community to this radical change at the time it was made. The tax treatment of capital assets with different useful lives is now generally regarded to be more neutral. However, some economists and members of the business community worry that the elimination of the investment incentive will discourage investment. (So far, there has been no effect because business was encouraged to invest during the transition period when a partial benefit from expensing was still granted.) A significant reduction in capital outlays in the last half of 1986 and in 1987 would cause considerable agitation to restore the tax incentive for investment. However, the government says it has no intention to capitulate.

Despite paying lip service to the idea of a comprehensive income tax, the present government has narrowed the tax base by providing new incentives for saving and equity investment. The capital gains tax has been reduced by gradual increases in the amount of capital gains exempt from tax (it is now £5,900); in addition, since 1982 gains

have been adjusted for inflation. A new scheme to encourage venture capital investment was put in place in 1984, and in 1986 another scheme to encourage individuals to invest in corporate stock was introduced. Finally, business and partnership losses generated by large interest deductions may be used to reduce taxable wage and salary income of individual investors. The net tax on capital income is, therefore, minimal, even if it is not negative. A few tax experts worry about this state of affairs, but no action is in prospect to stop the erosion of the tax base.

Tax Reform. The government continues to support further reduction in tax rates but does not couple this recommendation with base-broadening. Thus, the amount of rate reduction it can afford is limited, given budgetary constraints. Knowledgeable people in England admire the progress being made in the United States on tax reform, but they do not believe that the U.S. experience can be duplicated in Britain. In particular, I did not find anybody who thought that capital gains would ever be taxed like ordinary income in Britain. Most experts agree that the numerous savings incentives should be eliminated, but that is unlikely to happen under the current government.

Canada

Canada has recently reduced its corporate tax rates and eliminated its investment tax credit. It has also introduced a generous lifetime exemption of \$500,000 for capital gains. The major tax reform now under serious discussion is the substitution of a business transfer tax for the manufacturer's excise tax. The government is considering broadening the tax base and reducing individual income tax rates along U.S. lines, but the minister of finance would have to reverse his field to implement such an approach.

Capital Gains. The 1985 budget introduced a lifetime exemption for realized capital gains, with a phase-in over a six-year period. The exemption begins at \$10,000 per taxpayer in 1985 and will rise to \$500,000 in 1989. Capital gains above these limits are taxed at half the rates on ordinary income. Opinion is almost unanimous that this generous treatment of capital gains will have serious revenue consequences. Already shifts of property are taking place among family members to cash in on multiple lifetime exemptions. And investment counselors are advising clients to take advantage of the exemption now because of the possibility it will eventually have to be reduced or eliminated.

Investment and Capital Income. As in most countries, Canada provides investment incentives through the tax system. These inducements include an investment tax credit of 7 percent (10 percent for designated slow growth areas and 20 percent for the Atlantic provinces and the Gaspé Peninsula). The credit will be phased out beginning in 1987, except for investment in the slow growth areas, the Atlantic provinces, and the Gaspé.

In the 1986 budget, the minister of finance justified the phaseout of the investment tax credit on the ground that it is desirable to reduce disparities in effective tax rates across types of assets and industries. Business in general is not upset about the elimination of the credit, particularly since it was coupled with a cut in the corporate rate (see

below). Generous treatment of research and development will continue.

The Canadian income tax contains a number of provisions designed to promote saving. Employer contributions to registered retirement plans (RRPs) are not taxable up to \$3,500 a year per employee; employees are allowed to contribute an equal amount tax-free. For workers not covered by pension plans, deductions are allowed for contributions to registered retirement savings plans (RRSPs) up to \$7,000 of earned income. Tax-exempt limits on contributions to RRs and RRSPs are being increased gradually from \$7,000 in 1986 to \$15,550 in 1990. In addition, \$1,000 of interest and dividend income from Canadian sources and the first \$1,000 of pension income are not taxed.

It is not clear whether the incentives for saving have accomplished their objectives. Some tax experts believe that total saving has not increased as a result of the tax incentives. However, the share of savings in sheltered form (mostly retirement savings) has increased sharply, and support for the retirement saving provisions is widespread.

The Corporate Tax. The corporate tax rate in Canada is being reduced from 46 percent to 43 percent (from 43 percent to 40 percent in manufacturing) by 1989. The lower rate on manufacturing was a direct response to adoption in the United States of DISC (domestic international sales corporation) and later FISC (foreign international sales corporation) to defer taxes on export earnings. Canadian recipients of dividends from Canadian corporations are allowed a credit to reduce the double taxation of dividends. Beginning in 1987, the stockholders' dividend credit will be reduced from 50 percent to 33.3 percent to avoid giving relief where corporate tax was not paid. This reduction was combined with a reduction in the tax rate on small corporations. As a result, the situation (at the federal level) is approximately full integration for small companies, underintegration for large taxpaying companies, and overintegration for large nontaxpaying companies. Taking into account provincial taxes, the position will be less clear-cut. For example, small businesses in Ontario and Quebec will be overintegrated.

Overintegration occurs when dividend tax credits are given whether or not corporate taxes are paid. An advance corporate tax along European lines would deal with the problem, but Canadians want to avoid giving the credit to foreign shareholders. Moreover, dividend relief is regarded primarily as an incentive measure (to promote equity investment) and only secondarily as a device to eliminate double taxation.

The Value-Added Tax. A general consumption tax, known as the business transfer tax (BTT), is being widely discussed in Canada as a substitute for the manufacturer's excise tax, which introduces distortions and is bitterly resented by manufacturers. The BTT is calculated by subtracting purchases from sales to obtain value added. Experts in the government believe that this type of tax is easier to administer than the invoice-type VAT used in European countries, under which each enterprise calculates the tax on its total sales and then takes credit for the taxes paid by the suppliers. Moreover, the European-style VAT is opposed by Canada's provincial governments, all of which levy a retail sales tax.

Tax Reform. As already noted, major tax changes are

*"It is not clear whether
the [Canadian] incentives
for saving have
accomplished their objectives.
Some tax experts believe
that total saving has
not increased as a result
of the tax incentives.
However, the share of savings
in sheltered form . . .
has increased sharply. . . ."*

scheduled to take place in Canada over the next few years. The investment credit is being eliminated, the corporate tax rates lowered, and the capital gains tax sharply reduced. Introduction of a BTT has been temporarily deferred for political reasons, but the government is still interested in it. Public and private tax experts support action along the lines of the U.S. tax reform, but the government has been moving in the opposite direction since it took office in 1983. However, the impending reduction of the individual and corporate tax rates in the United States has already had a major impact on Canadian tax planning.

The Potential for Tax Revision

The tax systems of the six European countries and Canada are clearly in need of reform both to improve equity and to eliminate the economic distortions generated by tax preferences. Tax rates in these countries are high, but it is claimed that there is not as much room for base-broadening to finance significant rate cuts as there was in the United States. Nevertheless, the U.S. tax reform has greatly impressed politicians and tax experts alike, and much soul-searching is going on about the practicability of the U.S. approach in the various countries.

The skepticism about the potential of base-broadening stems in part from the different perspective of European tax officials. For example, capital gains on financial transactions are, in general, not subject to tax or are taxed at preferential rates in Europe, and few people believe that it would be politically feasible to tax them as ordinary income even at much lower rates than those now in effect. Moreover, nobody believes that it is possible to tax capital gains in full and limit the capital loss deduction to anything like the \$3,000 limit in the United States. The new U.S. restrictions on deductions for investment interest are also regarded as particularly severe in those countries that allow full deductions. The savings incentives are more vulnerable to revision, but the revenue losses from these provisions are said to be relatively small in most of these countries (except, of course, for the favorable treatment of pensions, which was virtually untouched in the U.S. tax reform).

Despite the many problems inherent in their income taxes, European governments are not likely to substitute a graduated consumption expenditure tax. A few academic experts in Sweden, Germany, and the United Kingdom actively support this sort of tax, but so far they have had little influence on government policy-makers. European tax officials dismiss an expenditure tax both because consumption is already heavily taxed through the VAT and because the transition to an expenditure tax raises difficult equity and administrative problems.

Europe's heavy reliance on the payroll and value-added taxes is not likely to change in the foreseeable future. Imposing heavy taxes on labor when unemployment rates are high is widely recognized as unwise, but payroll tax reductions are not in prospect because the revenues are needed to finance social welfare programs. The only revisions likely to be made in the VAT, now firmly entrenched, are removal of exemptions and multiple rates to simplify compliance and administration.

Europe is ahead of the United States in tax simplification in one major respect: elimination of the requirement to file tax returns by the large mass of wage earners. Sweden has

"Europe's heavy reliance on the payroll and value-added taxes is not likely to change

in the foreseeable future.

Imposing heavy taxes on labor

when unemployment rates

are high is widely recognized

as unwise, but payroll tax

reductions are not in prospect

because the revenues

are needed to finance

social welfare programs."

already decided to calculate taxable income and tax for all taxpayers beginning in 1987. The Dutch are weighing the proposal of its tax reform commission to go to a two- or three-bracket income tax system, with the first bracket applying to about 90 percent of all taxpayers. This system would enable the tax collection agency to excuse about a third of the taxpayers from filing annual tax returns. The United Kingdom expects to simplify its withholding and filing procedures at the end of this decade, when a new computer system will be installed in the tax collection agency. In the United States, the Treasury is studying the feasibility of a return-free system, but it has not yet completed its investigation. These developments are being followed carefully in other countries.

Post-Reagan Politics

A. James Reichley

THE 1986 ELECTION, followed swiftly by the appearance of disarray in the Reagan administration's conduct of foreign policy, will probably be identified in history as the beginning of the post-Reagan phase in American politics.

Statistically, President Reagan's Republican party did reasonably well in the election, measured by the standard of parties holding the White House in a second midterm election. The Republicans' net loss of eight seats in the Senate was about average for such elections in the twentieth century, and their drop of five in the House was far below the average "six-year-itch" decline of 40 seats. The Republicans' net gain of eight governorships, including the important prizes of Texas and Florida, contrasted with an average loss since the Second World War of six by the party in power nationally. Even in the Senate races, Republican candidates actually won a larger percentage of the total vote in 1986 than they had while gaining 12 seats in 1980.

Nevertheless, the size and sweep of the Democrats' recovery in the Senate, which the administration and both national party leaderships had accepted as the critical test of 1986, dispelled the sense of Reagan's invincibility that has permeated national politics during the last six years. This change does not mean that the president need be governmentally ineffective during the remainder of his second term. As President Eisenhower demonstrated after the much greater Democratic victory in the midterm election of 1958, a skillful president who knows what he wants will always be the single most powerful force in the American governmental system. It does assure, however, that the political system of parties and elections will now be geared toward the future.

A Trap for Democrats

Prior to the 1986 election, many Republican leaders were inclined to believe that they could continue to win political victories simply by keeping Reaganism rolling — in a sense by convincing voters that Ronald Reagan was still on the ballot. They now know this strategy is insufficient. The Reagan years have wrought major changes in the structure of national politics. Reagan's overall approach to government, if not some of his specific policies, appears to remain popular with the voters. But if the Republicans are to build further on the political gains they have made since 1980, they will have to embody their conservative governmental philosophy in policies responsive to current realities and problems, including some that rise from Reaganism itself.

In 1986, the Republicans relied on high-tech campaigning and their advantage in financial resources, coupled with the president's personal popularity, to bring them victory. They failed. They now have both a need and an opportunity to

A. James Reichley is a senior fellow in the Governmental Studies program at Brookings and is the author of several books on American politics, including Religion in American Public Life. He is currently working on a book entitled The New Party System.

develop fresh practical adaptations of conservative principles and values.

The Democrats have been lifted out of the morass of depression that has beset them since 1978. As David Broder has written, they have discovered that "the gods do not despise the Democrats as much as recent history had made us think." There is now a realistic chance that the Democrats will regain the presidency in the next election. The size of their new majority in the Senate gives them a cushion against possible losses resulting from the large number of Democratic seats that will be at stake in 1988. Democratic dominance of the House of Representatives seems as secure as it has been for the last 30 years.

But there is a trap in the 1986 results for the Democrats at least as dangerous as that which recently ensnared the Republicans. Democrats are now tempted to conclude that they remain the normal majority party, reliably returned to power by the voters after unnatural flings with personally attractive conservative leaders like Eisenhower and Reagan. If they think that, they will be wrong. The normal majority based on the New Deal coalition that dominated American politics from the 1930s to the 1970s has passed, probably irretrievably. There is today *no* normal majority party in the United States. The CBS-*New York Times* survey of voters leaving the polls in 1986 found 39 percent identifying themselves as Democrats and 34 percent as Republicans—a huge change from the division of 48 percent Democrats to 24 percent Republicans recorded as recently as 1979. Either party can win elections, and the future belongs to the one that comes closer to meeting voters' aspirations and concerns.

The political strategy dictated by retiring House Speaker Thomas P. O'Neill, and accepted more or less by default by Senate Democrats, was at least superficially vindicated in 1986. O'Neill's view after Reagan's massive victory in 1984 was that the congressional Democrats should not offer a distinct legislative program but rather should allow the administration's policies to fall of their own weight. Observing Walter Mondale's fate in the last presidential election, Speaker O'Neill argued the Democrats should propose no initiatives that would require an increase in taxes and indeed should agree to raise taxes only if the president asked them to do so "on his knees." Sooner rather than later, O'Neill and his political advisers predicted, a majority of voters would come to their senses and return to their natural home with the Democrats.

The large Democratic gain in the Senate can be interpreted as bearing out this expectation. The advance in the House was less marked, it is argued, only because the Democrats had lost so few seats in 1984 that they had few good prospects for gains in 1986. (In the final years of Reagan's presidency, the Republicans will hold only 20 more seats in the House than they did the year before he was elected—still more than 80 seats away from a majority.)

The trouble with this strategy is that it has brought the Democrats to comfortable majorities in both houses of Congress with almost no discernible legislative agenda. The one possible exception is a swing toward protectionism on trade, which in the end would probably do the Democrats more political harm than good.

Conceivably, congressional Democrats will use the next two years to develop a comprehensive governmental program on which to run in 1988, even if much of it cannot be

enacted as long as Reagan remains in the White House. Something like this happened after the Democratic victory in 1958. Liberal Democrats in Congress put together a program that Eisenhower largely blocked, but that later served as the basis for sweeping economic and social changes enacted under Presidents Kennedy and Johnson, as James Sundquist has described in *Politics and Policy*.

This course of action, however, would require the Democrats to make hard choices in areas like defense, taxation, and the budget. Reputations can be made by congressional Democrats prepared to get out front on some of these issues. But those who believe in waiting for disenchantment with the Republicans to carry the Democrats back to the White House are more likely to concentrate on exploiting the political fallout from the administration's dealings with Iran and duck broader governmental problems.

Turnout Turndown

Some possible contours of the post-Reagan political future can be found through close analysis of the 1986 results. The most important political fact of 1986 was low turnout. National turnout, according to Curtis Gans at the Committee for the Study of the American Electorate, fell to just over 37 percent of potential voters, compared with 53 percent in 1984, and 41 percent in the last midterm election in 1982. This drop-off continues a trend that has been under way since 1960, when turnout reached a peak of 59 percent. Decline in voter participation in most parts of the country has been even more precipitous than these national figures suggest. Before enactment of the Voting Rights Act of 1965 and the emergence of Republicans as serious contenders in most southern states, exceptionally low turnouts in general elections in the South depressed national averages. Since the 1960s, southern turnout has increased, but not enough

*"... the size and sweep
of the Democrats' recovery
in the Senate... dispelled the
sense of Reagan's invincibility
that has permeated
national politics
during the last six years."*

to offset steep decline in the rest of the nation.

Clearly, growing numbers of voters see no reason to go to the polls on election day, despite intensive get-out-the-vote efforts by both major parties and various nonpartisan civic groups. Some interpret low turnout as a sign of contentment: if things are going reasonably well and the out-party poses no serious threat to the status quo, why bother to choose between Tweedledum and Tweedledee?

There may be something to this, but darker explanations seem on the whole more plausible. Legislators from both parties have been so ingenious at carving out congressional and legislative districts in which candidates of one party or the other are prohibitive favorites that a large part of the potential electorate understandably may feel that voting has only symbolic effect. Worse, the continuing degradation of campaigns by the rising prevalence of 30-second television commercials as the chief means through which candidates communicate with voters has heightened the always strong tendency among Americans to regard politics with disgust. These commercials have increasingly concentrated on insulting the character or personality of opposing candidates, further motivating voter rejection of the entire process. In many states and even congressional districts, old-style campaigning in which candidates traveled from town to town or ward to ward setting forth their views on issues, though usually in highly simplified terms and sometimes with demagogic flourishes, has largely disappeared. Many candidates now appear for only a few minutes each day to provide photo opportunities to the media, and then rush back to the telephone to raise more money to pay for vacuous or defamatory commercials.

Whatever the reason, there is now a huge bloc of voters who are making no direct impact on the electoral system. It is worth recalling that major political realignments in the

past have often come when blocs of formerly passive potential voters have been mobilized behind parties or candidates. Whether current nonvoters would cast ballots that would significantly alter the party or ideological balance is contestable. But they certainly hold it within their power to set new directions in national politics.

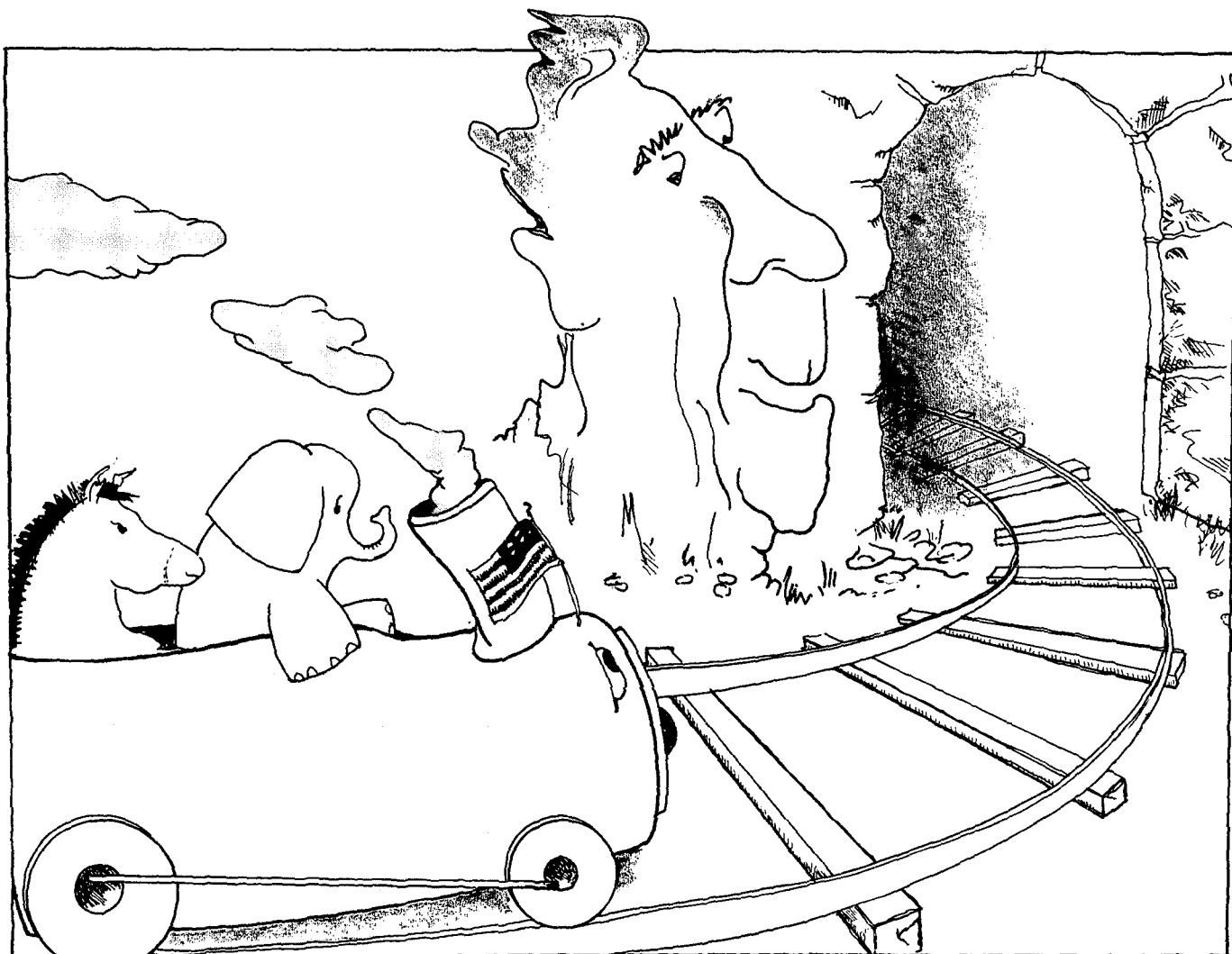
Passive Republicans

The decrease in turnout has not been uniform across demographic groups. Turnout decline in 1986 was particularly severe among two important components of Reagan's 1984 coalition: white evangelical Protestants and voters under the age of 30.

The ABC-*Washington Post* election day survey found that white evangelicals made up only 12 percent of voters in 1986, compared with 17 percent in 1984. Among white evangelicals who did vote in 1986, slightly more cast ballots for Republican candidates for the House of Representatives than in 1984. The decline in voting among evangelicals by itself was probably enough to account for Republican setbacks in the South and possibly in some of the farm states of the Midwest.

Before 1984, voters under 30 had voted disproportionately Democratic in every election since modern opinion polling began in 1936. Gallup's final poll in 1984, however, found voters under 30 supporting Reagan more heavily than the electorate as a whole — giving Republicans reason to hope that they had at last become the party of the future. In 1986, the CBS-*New York Times* exit poll showed voters under 30 who voted for major party candidates for the House of Representatives supporting Democrats by 51 percent to 49 percent — but this age group was the least Democratic and most Republican of any age group in the

*“Worse, the continuing degradation of campaigns
by the rising prevalence of 30-second television commercials
as the chief means through which
candidates communicate with voters has
heightened the always strong tendency among Americans
to regard politics with disgust.”*



population. First-time voters, generally the youngest, backed Republicans by a two-point margin. The big change among young voters between 1984 and 1986 was in turnout: voters under 30 made up 26 percent of the voting electorate in 1984 but only 17 percent in 1986. Turnout was also down compared with the last midterm election, when voters under 30 were 22 percent of the total.

Evangelicals and young voters generally have been among the relatively passive groups in the American electorate. Reagan, appealing to traditional moral values among the evangelicals and economic optimism and national pride among the young, attracted disproportionate shares of both groups to the polls in 1984. Large numbers of these 1984 Reagan supporters found no reason to vote in 1986. Republican hopes to achieve majority party status in the future depend largely not only on how evangelicals and young people vote but also on whether they can be stirred from electoral passivity.

Two mainstays of the New Deal coalition, Roman Catholics and Jews, voted in 1986, as usual, at levels above the national average. Jews supported Democrats in congressional elections by a majority of about two-to-one, almost exactly as they had done in 1984 though well below the percentage of Jewish support for Democratic candidates in most elections since Jews switched massively from the Republican party to the Democrats in the late 1920s. But

Catholics, more than one-fourth of the total electorate and a bulwark of support for the Democrats throughout most of American history, continued their gradual drift away from the Democratic party. According to the CBS-*New York Times* survey, only 55 percent of Catholics voted for Democratic candidates for the House of Representatives in 1986, down from 58 percent in 1984 and 63 percent in 1982. This decline would be even sharper were it not for the failure of Republicans to make sizable inroads among the fastest growing Catholic ethnic subgroup, Hispanics, who in 1986 gave three-quarters of their vote to the Democrats.

Blacks, historically a low-turnout group, came closer to the level of white participation in 1986 than in the last midterm election. This change had major political effect: blacks provided the margin of victory for Democrats who ousted incumbent Republicans in Senate races in Alabama, Georgia, and North Carolina. Blacks also gave the edge to the Democratic candidate for the open Senate seat in Louisiana.

Men and women shared the electorate in about the same proportions as they have recently: about 48 percent men and 52 percent women. The gender gap remained a factor, though less so in voting for the House than in 1984, because men voting for major-party candidates shifted from a small majority for the Republicans to a 51-to-49 edge for the Democrats. Women divided as they had in 1984, 54

The State of the Parties

During the 1985–86 election cycle, James Reichley interviewed politicians and political technicians all over the United States in connection with his current Brookings study of political parties. Some of their comments on factors affecting the vitality of the party system follow.

Money

Robert Strauss, former Democratic national chairman, Washington: As money becomes more important in politics, the parties become less important. Candidates no longer look to the parties for their financing. They get money directly from the PACs [political action committees]. As a result, the parties can't provide them with insulation against special interests.

Senator Richard Lugar, Republican, Indiana: It is just silly to say that we are spending too much on political campaigns. The amount of money spent on running for public office is really minor compared to what we spend on much less important purposes.

David Garth, consultant, New York: In state and local elections in New York, the Democrats are able to raise enough money to be competitive. But at the federal level, this is much more difficult. The universe is so much larger, and the reservoir of potential Republican contributors is much greater.

Campaign Technology

Lee Atwater, political adviser to Vice President George Bush, Washington: The parties are now making a transition to the communication age. The tradition of the Ray Bliss type of party was to have as chairman a person who was highly skilled at nuts-and-bolts organization. That is not what is needed today. What you look for today in a state chairman is someone who understands the media and will make a good spokesman for the party on TV.

Gordon Durnil, chairman, Indiana Republican Party, Indianapolis: In the late 1960s, the leaders of the Indiana Republican organization realized that in many states the consultants were taking over. We decided to teach ourselves the new campaign technology. The Republican organization developed a capacity for direct mail and handling demographics and other aspects of modern campaigning. As a result, politics in Indiana has remained party-oriented.

William Hamilton, Democratic consultant, Washington: Three things caused the parties to go downhill: the telephone, television, and the Model T. In other words, technology overwhelmed the parties. Now both parties are trying to develop national organizations that know how to make use of technology.

George Dunn, president, Cook County Board of Commissioners, Democrat, Chicago: I stay close to my people and give them what help I can when they have problems with the city and county governments. But television is the thing that really has the effect now on how people vote. It brings the candidates right into the voters' parlor and the organization can't compete with that.

Organization

Secretary of Labor William Brock, Washington: When I became Republican national chairman in 1977, the party was at such a low ebb that some people seriously suggested that the party should change its name. Among other things, I set out to win state legislatures and sheriffs' offices. For the first time the national party became involved in local primaries. This involvement was really a necessity. If the party did not grow at the local level, it would melt away.

William Meehan, Republican city leader, Philadelphia: It has been my experience that the people in Washington do not understand how a political organization works in Philadelphia. No national chairman is likely to know how to deal with the realities of politics in the twenty-second ward.

Pat Cadell, Democratic consultant, Washington: The national Democratic party is led by a mediocracy. Democratic leaders are like generals in the South Vietnamese army. They know the enemy is out there coming to get them, but they do nothing to develop their own national strategy.

Donna Ashby, Delaware County Recorder of Deeds, Democrat, Muncie, Indiana: Courthouse employees who work for Democratic county officeholders belong to the One Percent Club, which means they pay 1 percent of their salaries to the Democratic party. This is entirely voluntary, but we feel that those who get their jobs through the party should pay for part of the party's upkeep.

Jennifer Dunn, chairperson, Washington State Republican Party, Seattle: No governor today could dominate the state party the way Dan Evans did when he was governor in the 1970s. The party has more independence. The state chairperson would not be pushed around.

City Councilman Nat McFadden, Democrat, Baltimore: Party clubs are even more important as sources of campaign manpower since it has become so expensive to run for office. All the money that is available must be plowed into media advertising so the grassroots campaigning must be carried on by the clubs.

Ideology

Ann Lewis, national director, Americans for Democratic Action, Washington: There is growing recognition within the Democratic party that it is not sensible to keep drawing lines by which Democrats judge each other. We are devoting more attention to what divides Democrats from their opposition.

Governor Joe Frank Harris, Democrat, Georgia: In Georgia, the Democratic party has remained popular because it has stayed true to the principles of fiscal conservatism and red, white, and blue patriotism that the great majority, not only of Georgians, but of mainstream Americans believe in.

Morton Blackwell, conservative activist, Washington: The Republican party infrastructure has largely been taken over by conservatives. But conservatives have a saying: "By the time your people get where they can do you some good, they stop being your people."

State Representative John Burns, Republican, Concord, New

Hampshire: Party discipline in the legislature is practically nonexistent. The legislature is so large and the job pays so little that it is almost impossible to impose a party line. We do have a Republican caucus, but the philosophy of its members runs the full gamut from liberal to conservative.

William Lacy, political adviser to Senate Republican Leader Robert Dole and former political director of the Republican National Committee, Washington: The Reagan presidency has tended to polarize the electorate. People either like it or they don't. On balance, this has built up the Republican party because Reagan generally has represented what the mass of voters feel.

Karen Marchioro, chair, Washington State Democratic Party, Seattle: Local party people still have a tendency to be bowled over by elected officials. The elected officials come to dominate the party, rather than the other way around. On tough votes in the legislature, the elected officials feel free to take a walk if it does not serve their interest to support the position called for by the party.

Representative Barney Frank, Democrat, Massachusetts: Both parties are ideologically more united than they used to be. There is almost no congressional district in the country where the Democratic candidate is not more liberal than the Republican.

Mitch Daniels, White House political director, Washington:

*"We pay so much attention
to campaign themes
and technology
that we sometimes lose sight
of the importance
of the rules of the game —
the laws that structure
our political system."*

Parties give us the means to apply the market system to politics. Republicans and Democrats compete against each other very much the way rival companies compete in the marketplace. The parties have no strong ideological base.

Party Coalitions

Secretary of the Treasury James Baker, Washington: The coalition that reelected Ronald Reagan in 1984 was based primarily on economics. Social issues helped some, but they also cost some potential supporters. The great question for the future is whether identification of the Republican party with economic opportunity can be maintained.

Mayor Richard Arrington, Democrat, Birmingham: The best thing that could happen to blacks in Alabama would be the development of a real two-party system. But the Republicans have made almost no effort to attract black voters. At least in the perception of the black community, the Republicans are just the old Dixiecrats under a different label.

Russell Clutter, Calhoun County Republican chairman, Battlecreek, Michigan: The Republican party in Calhoun County is really divided between the country club set and grassroots workers. It used to be that only a certain few made all decisions. Since I opened up the party's leadership, most of the country club people no longer participate in party activities.

John Emerson, chairman, California Democrats for New Leadership, Los Angeles: People are very skeptical about organized parties in California. They are more attracted to participate in political caucuses, such as ethnic caucuses, lesbian caucuses, black caucuses, environmental caucuses, handicapped caucuses, and most recently Asian caucuses. The caucuses have come to play such a large part in the Democratic party that many lower-middle-class whites have begun to ask, "What room is there in that party for me?" These are the swing voters in close elections.

Willie Velasquez, voting rights activist, San Antonio: There is definite convergence between Mexican-Americans and the Republican party on social issues like abortion. But the positions taken by most Republican leaders on economic issues and on issues like bilingual education still limit the headway they can make among Hispanics.

Jim Duncan, Lee County Republican chairman, Auburn, Alabama: The problem for the Republican party in Alabama is to get the folks who vote Republican in national elections to vote for Republicans for the state legislature and the courthouse. It's a tough row to hoe, but we are beginning to bring them over.

Rules of the Game

Lance Tarrance, Republican pollster and consultant, Houston: We pay so much attention to campaign themes and technology that we sometimes lose sight of the importance of the rules of the game — the laws that structure our political system. These strongly support a continued major role for the Republican and Democratic parties.

percent Democratic to 46 percent Republican. The Democratic advantage came chiefly from unmarried women, among whom the Democrats led by 16 percentage points, compared with a lead of 6 points among married women — reflecting in part, one may guess, the severe economic and social hardships being suffered by many formerly married women now raising families.

Looking Toward Reapportionment

The brightest result for the Republicans in 1986 was their net gain of eight governorships, overcoming the historic pattern that almost always has produced losses of governorships in midterm elections for the party holding the White House. Some of these gains were in normally Republican states of the Midwest where Democrats had won governorships in earlier elections largely through personal popularity. But the election of Republican governors in four southern states, Texas, Florida, Alabama, and South Carolina, indicates that casting ballots for Republicans for state and local offices is at last becoming an acceptable option in states of the old Confederacy that have voted Republican in most recent national elections but where Democrats have generally remained dominant in statehouses, county courthouses, and city halls.

Some Republicans claim that their gain in governorships means their party will be in a position to achieve more favorable apportionment of congressional and legislative districts after the 1990 census — the political mother lode toward which both parties are now pointing. But in Texas and Florida, two fast-growing Sunbelt states that between them will gain at least six new House seats after the next census, Democrats retained overwhelming majorities in the legislatures, where reapportionment will begin.

In Texas, perhaps the single most important state in the current national electoral balance, Republicans did pick up more than 100 offices in municipal and county governments, but made little effort to win most statewide offices

except the governorship. Reelection of William Hobby, laird of a notable Houston family, as lieutenant governor gives the Democrats a natural focus for opposition to Republican William Clements, elected once more to the constitutionally weak Texas governorship after being ousted by a Democrat in 1982. One promising sign for the Republicans was the close race for state attorney general by Roy Barrera, the first Hispanic nominated for statewide office on the Republican ticket. If Barrera, who is only 34, remains active in state politics, he may come to serve as a Republican counterpart among Hispanics to Henry Cisneros, the popular Democratic mayor of San Antonio.

In California and Illinois, the two megastates that reelected Republican governors in 1986, Democrats retained majorities in both legislative houses. California Republicans won several open seats in the legislature, leading some commentators to foresee the possibility of Republican control by 1990. Republican Governor George Deukmejian was reelected by a majority of more than 20 percent. But unlike California's last Republican governor, Ronald Reagan, Deukmejian has not been a specially partisan figure and did not run in close association with his party's candidates for other statewide offices, such as lieutenant governor, attorney general, and controller. Democrats won all of these offices by comfortable majorities, in some cases with only token opposition.

In Illinois, Governor James Thompson, a likely contender for the 1988 Republican national ticket, won reelection to a fourth term by an impressive majority of 13 percent. Thompson was helped back to office by the imbroglio caused for the Democrats when followers of the radical eccentric Lyndon LaRouche won nominations on the Democratic ticket for the offices of lieutenant governor and secretary of state. The LaRouchites were duly trounced by their Republican opponents, but Democrats won easy victories for other statewide offices. A notable achievement for the Republicans in Illinois was election of their candidate, James O'Grady, as sheriff of Cook County, an office which

“ . . . the election of Republican governors in four southern states . . . indicates that casting ballots for Republicans for state and local offices is at last becoming an acceptable option in states of the old Confederacy . . . where Democrats have generally remained dominant in statehouses, county courthouses, and city halls.”

in the past has been an important asset in the fight for control of one of the largest swing states in national elections.

Capture of the Pennsylvania governorship by Democrat Robert Casey, successful after three previous defeats, closed the chain of older industrial states under Democratic dominance stretching from Massachusetts to Michigan. But in the four most populous of these states, New York, Pennsylvania, Ohio, and Michigan, Republicans maintained control of the state senate, preserving Republican beachheads on the approach to reapportionment.

Realignment Deferred

The conventional wisdom that parties in general are in decline and that politics at all levels has become candidate-oriented was bolstered in 1986 by extreme examples of ticket-splitting in some state elections. In New York, Democrat Mario Cuomo was reelected governor with a majority of 65 percent, while Republican Alfonse D'Amato was returned to the Senate with 58 percent. The spread in California between Republican Deukmejian for governor and the losing Republican candidate for the Senate was 13 points. In South Carolina, Democrat Fritz Hollings was reelected to the Senate with 64 percent while Republican Carroll Campbell slid into the governorship with 52 percent.

Signs of substantial impact by party, however, were reflected in some 1986 results. The Democratic sweep of Senate seats in the South resulted in large part from unswerving loyalty by most blacks to the Democratic label and revival of Democratic loyalties among just enough whites to constitute a majority. In most southern states, Democratic candidates still have the advantage at the state and local levels, except when faced by unusually strong opponents, like Campbell of South Carolina or Bob Martinez, the successful Republican candidate for governor in Florida, or by extraordinary situations, like the controversy over the disputed Democratic gubernatorial primary in Alabama that clearly turned off many voters.

Party also seemed to play a part in the defeats of incumbent Republican senators in North and South Dakota and the election of liberal Democrat Timothy Wirth to Gary Hart's old Senate seat in Colorado. Some voters in these states seemed to be signaling their discontent with the agricultural policies of the Reagan administration. (Just what kind of farm policies would be regarded as acceptable is another question.) At the state level, however, many midwestern states asserted their normal Republicanism.

Mass parties supported by armies of intensely loyal adherents of the kind that existed in the United States in the late nineteenth and early twentieth centuries are clearly a thing of the past. Political activists today are more likely to be captivated by causes or candidates than by party enthusiasms. Most voters, however, continue to have a normal preference for one party or the other. Victory in most states goes to the party that does the better job of mobilizing its base and then is able to win the larger share of independents and ticket-splitters.

Party realignment, much discussed after the 1980 and 1984 elections, was at least postponed but not necessarily forestalled by the 1986 results. The nation has now moved from what Everett Carl Ladd used to call a "one-and-a-half" party system to a full-fledged two-party system. The question remains whether national power will continue to

"Political activists today

are more likely to be

captivated by causes

or candidates than by

party enthusiasms.

Most voters, however, continue

to have a . . . preference

for one party or the other."

bounce back and forth between the two major parties, kept in play by a fluctuating electorate, or whether we are going through a time of transition in which voters are sorting out new loyalties, as occurred during the periods that preceded major realignments in the 1860s and 1930s.

A Repudiation of Reaganism?

Commentators who found in the 1986 results clear signs of movement away from the more ideological national politics that began in the 1960s may also have been premature. Neither party, it is true, placed much emphasis on ideology in 1986. But at least some Democrats may now be emboldened to revive or update liberal themes. And Republicans, looking toward 1988 and beyond, may conclude that campaigns based mainly on personality and generalized optimism are not likely to succeed.

My own reading of the message of 1986 is not that it represents repudiation of Reaganism, if Reaganism is interpreted to mean support for a market-oriented economy, firm defense of American interests, and advocacy of traditional moral values. Rather, the returns are an indication that many voters feel uneasy with some phenomena, such as massive federal budget and trade deficits, vast economic inequality, or insufficient attention to moral aspects of foreign policy, that they have come to regard as unnecessary accompaniments of contemporary conservatism. The party and the candidates that do best at meeting these concerns, while preserving the genuine progress that has been achieved since 1980, should reap rich electoral rewards as the nation moves into the next political era.

O'Neill's Legacy for the House

Steven S. Smith

WHEN THOMAS P. "TIP" O'NEILL became Speaker of the House of Representatives in 1977, he seemed to be all things to all people. Press previews of his speakership noted an amazing array of personal qualifications that O'Neill would bring to the job. He was loyal to friends and the Democratic party, popular with his colleagues, genial, gregarious. He had no enemies. He was a ward heeler, a backroom pol, a graduate of the Sam Rayburn school of bargaining and accommodation. He was nondoctrinaire, grandfatherly, tough-minded, shrewd, an activist, a partisan, a gut liberal, adaptable.

By the end of the Carter administration, the high expectations began to turn into disappointments among many House Democrats, especially O'Neill's fellow liberals. O'Neill lost key votes while supporting a Democratic president who grew increasingly unpopular within his own party. The Speaker's darkest hour came in 1981 when he was unable to hold House Democrats together and prevent enactment of President Reagan's budget and tax packages. Yet, not much more than a year after pundits predicted that O'Neill would have to give up his speakership, he once again became the hero of his party. O'Neill retires at the end of the 99th Congress, having served the longest uninterrupted term as Speaker in the history of the House, with his standing in public opinion polls nearly as high as President Reagan's.

O'Neill's lasting contributions to the speakership, however, go beyond personality and popularity. He leaves concrete innovations in leadership and party practice that will be the starting points for his successor. To be appreciated, these innovations must be seen in the context of his colleagues' expectations and Democratic party strength in the House. Once these effects are outlined, the advantages and disadvantages of O'Neill's leadership style and organizational innovations can be illuminated. Finally, I turn to some lessons for the next Speaker.

Context and Leadership Style

Two propositions about O'Neill's leadership style seem reasonable.¹ First, *it was shaped more by the institutional context of the House than by his personal traits.* O'Neill became Speaker when the House was mired in uncertainty and confusion. His predecessor, Carl Albert, was soft-spoken, intellectual, sometimes aloof, a centrist Speaker who presided over the convulsive period of House reform from 1971 through 1976. Appreciated for his willingness to allow party and committee reforms to proceed, Albert did not aggressively employ new powers granted to the Speaker. As a result, he was roundly criticized for his indecisiveness, for his inability to stand up to obstructionist committee chairmen, for failing to provide direction to Democratic opposition to Presidents

*Steven S. Smith is a senior fellow in the Brookings Governmental Studies program. He is the author of *Committees in Congress* and the forthcoming *Winning and Leading in Congress*. In 1980–81 he served on the staff of the Democratic Steering and Policy Committee.*

Nixon and Ford, and for making important decisions by himself.

In fairness to Albert, it is unlikely that any Speaker would have presided successfully during this transition period. Committee reforms of the early 1970s stripped full committee chairmen of their ability to appoint subcommittees, withhold legislation and staff from subcommittees, and delay reporting legislation to the floor. Each committee chairman was required to face a secret ballot election in the Democratic caucus every two years. Party reforms reactivated the caucus, enhanced the Speaker's role in making committee assignments, gave him discretion to refer legislation to more than one committee, and strengthened his control of the Rules Committee. Sunshine reforms increased recorded voting and amending activity on the floor and opened committee meetings to the public. The thrust was strongly egalitarian, reducing the strong hold of full committee chairmen over the legislative process of the House.

O'Neill was an old-style politician who realized that the post-reform House called for a new style of leadership. He knew that his approach for dealing with other House leaders, committees, and especially the rank-and-file would have to be different, at least in part, from the style of his predecessors. In fact, he was the first to admit that his political personality was better suited to the House of the 1950s and early 1960s than to the House of the late 1970s and 1980s. As Speaker, he was faced with the disintegration of the seniority system, new issues cutting across old party cleavages, and greater independence from party among Democratic members. Recognizing that he was seen as a political dinosaur in some quarters, O'Neill sought to reassure new members soon after the 1976 election: "... you can teach an old dog new tricks if he wants to learn. And this old dog wants to learn."

O'Neill's style blended the old and the new. Like Speakers before him, he tended to operate on a very personal, reactive, and accommodating basis. Patronage, favors for loyalists, and deference to the president of his party were common elements of his daily activity before he became Speaker, and they remained crucial elements of his leadership style. O'Neill did not intervene in committee deliberations, except in the most unusual circumstances, unless he was invited to participate. The only committees he monitored regularly were Appropriations, Budget, Rules, and Ways and Means. Like his predecessors, O'Neill avoided the use of party organs to air divisive issues or debate committee legislation, and he seldom challenged the policy recommendations of the standing committees. He continued to endorse the seniority system, supporting senior members for committee and subcommittee chairmanships against more junior challengers.

Friendship, not sanctions, was the bedrock of his style. As O'Neill explained to the *National Journal* in 1977, "I have an open door policy. Rare is the occasion when a man has a personal fund-raiser or is being personally honored that I don't show up at it. I've made more public appearances and visited areas if they believe I can help them. I'm always accessible. These are part of the duties and the obligations of the Speaker, and it shows the warm hand of friendship." Four years later, responding to critics who challenged his effectiveness, O'Neill reiterated this theme. "Let me tell you something," he told a *Washington Post* reporter in May

1981, "there's never been a man in the history of Congress that has as many friends on that floor as I have. And let me tell you — solid friends. And a solid friend is a man's best defense. I've got guys out there who would *fight* for Tip O'Neill." Not just anyone can wield influence through friendship. O'Neill, like Rayburn, considered his ability to make strong friendships a personal strength that he deliberately developed and reinforced as a component of his leadership style.

The contours of O'Neill's stylistic innovations also were visible from the start. A central element was his focus on managing the policy alternatives presented on the House floor. Barbara Sinclair has appropriately called this "structuring the choice situation."² The stimulus was a broad set of problems that beset House decision-making in the early 1970s. Issues, like the energy crisis of 1973–74, that fell into the jurisdictions of many committees made the timely development of comprehensive legislative packages very difficult. The advent of electronic, recorded voting in 1973 stimulated an avalanche of amending activity on the floor. More inexperienced members, with less experienced staff, were managing bills on the floor. Members complained about the unpredictability of when and where policy decisions would be made.

O'Neill's first effort to bring some order to House decision-making worked well. Even before formally taking office, he promised to create an ad hoc committee to craft comprehensive energy legislation, which President-elect Jimmy Carter had made a top priority. Although he could not bypass the standing committees and had to carefully limit the ability of the ad hoc committee to alter the recommendations of the standing committees, O'Neill's approach was successful. By the end of 1977, the House had passed the bulk of President Carter's energy package. Yet O'Neill was never able to use the ad hoc committee technique successfully again, largely because of policy differences and jurisdictional jealousies among the standing committees.

*"O'Neill was
an old-style politician
who realized that
the post-reform House
called for a
new style of leadership."*

"A Speaker's success is ultimately judged on how much of his party's legislative agenda is adopted. . . . Legislative victories in the House depend on votes, and the number of like-minded Democrats has a greater impact on votes than leadership style. And the size of the Democratic contingent in the House varied greatly during O'Neill's speakership. . . ."

A more important tool was O'Neill's aggressive use of the rules governing floor debate to mold policy choices for the House on major legislation. O'Neill's greater control of Democrats on the Rules Committee and its increased use of restrictive, complex rules, which detailed the floor amendments that could be offered, helped to structure amending activity and improve scheduling for the floor. The emphasis on setting the agenda and minimizing surprises on the floor reduced the need for last-minute arm-twisting and eased the severity of attendance problems.

A second new component: O'Neill deliberately sought to expand participation in party councils to more, and to more junior, Democrats. He enlarged the whip system, created task forces to assist the leadership on major issues, and encouraged the expression of opinions through his explicit open-door policy. This "strategy of inclusion" drew in the resources of more members, minimized the need for coercion, and, perhaps most importantly, helped meet the rank-and-file's demands for more avenues of participation. More members had a stake in the success of the leadership and may even have been coopted to the leadership point of view on occasion.

Finally, but much more gradually, much less deliberately, and less completely than was true for other elements of his style, O'Neill developed a more assertive media role than his predecessors. His facility for public speaking to the contrary, O'Neill adapted to the use of the media — partly out of necessity and partly by accident. After Reagan's election in 1980, O'Neill was thrust into the limelight as the most senior elected Democrat. In 1981, when Reagan dominated television coverage, O'Neill was criticized for failing to set before the public a coherent, effective Democratic response. At the same time, the O'Neill aide who handled media relations decided to join a lobbying firm. His replacement, Christopher Matthews, took the criticisms to heart and gradually moved the Speaker to be more assertive. Attendance at the Speaker's daily press conference improved, and he gained substantial coverage on network news programs and in the national press. This is not to say that he suddenly gained new media skills — O'Neill was known to read reporters his press releases from top to bottom, including "Statement of Thomas P. O'Neill, Jr." at the bottom of the page. Nonetheless, he increased the public visibility of the Speaker and improved his standing with his colleagues.

Party Strength, Style, and Policy Success

Second, *O'Neill's success was determined more by the size and cohesiveness of his party than by his leadership style.* O'Neill's leadership style, as essential as it was to the situation he faced in 1977, must be seen in the context of Democratic party strength in the House. A Speaker's success is ultimately judged on how much of his party's legislative agenda is adopted and how much of the opposition's agenda is blocked. Legislative victories in the House depend on votes, and the number of like-minded Democrats has a greater impact on votes than leadership style. And the size of the Democratic contingent in the House varied greatly during O'Neill's speakership (see table 1). The contingent of 292 Democrats with which O'Neill began his speakership in 1977 was a larger number than in any of the four previous Congresses and was substantially

higher than the 1955–76 average of 258. The group of 242 Democrats of Reagan's first Congress, the 97th, was the lowest number in any Congress since Eisenhower's first term. O'Neill's success in passing or blocking legislation — and his reputation as an effective leader — closely paralleled the electoral fortunes of his party in the House.

O'Neill emerged from his first year as Speaker as a hero to his party and his party's president. He exercised a strong hand in instructing President Carter about the ways of Congress, promising that "we'll make this guy . . . a great president." Despite friction between O'Neill and Carter on several personal and political issues, O'Neill and the House managed to pass the bulk of Carter's energy program and a social security tax increase. The Speaker appeared to be filling the leadership void created by Carl Albert's weaknesses and the Carter administration's legislative ineptitude. In an article entitled "Tip O'Neill: A Legend Being Born," a *Washington Post* reporter wrote in August 1977 that O'Neill's "colleagues now attribute all sorts of happenings to the workings of O'Neill, whether he was within miles of the event or not."

The rest of Carter's term proved increasingly more frustrating. Carter's problems, and O'Neill's, multiplied as the 1978 election approached. Over 92 percent of House Democrats had run ahead of Carter in their districts in 1976, and they became less tolerant of what they considered an ineffective administration as the 1978 elections approached. Caught between loyalty to a Democratic president and his obligations to his colleagues, O'Neill sometimes supported the administration's position and lost, as he did on consumer protection and tax legislation. In other cases, such as the public works bill, he deserted Carter to join the majority of his party colleagues. Weakened by the loss of 15 Democratic seats in 1978, O'Neill lost four significant votes in the span of one week in September 1979, prompting rumors that he "might retire, discouraged by his inability to control the House and disgruntled with the younger Democrats whose conservative bent and lack of party loyalty he doesn't understand."³

1981 was O'Neill's most difficult year in office. The Democrats lost the White House, the Senate, and 34 House seats in the 1980 election. O'Neill could afford to lose only 25 Democrats on floor votes if the Republicans voted together. Given the magnitude of Reagan's election victory and his extraordinary personal popularity, the Republicans were more likely than usual to be cohesive. The Democrats, traditionally divided by deep regional and ideological divisions, were even less likely to remain cohesive when facing a popular, conservative president. Conservative Democrats, recognizing their pivotal posi-



Table 1.
House Lineup During O'Neill's Speakership

Congress	Democrats	Republicans
95th (1977–78)	292	143
96th (1979–80)	277	157
97th (1981–82)	242	189
98th (1983–84)	268	165
99th (1985–86)	253	182

tion in the ideological balance of the House, formally organized for the first time. The Conservative Democratic Forum (CDF) threatened to bolt the party on key procedural motions and successfully demanded from O'Neill seats on key legislative committees and the party's Steering and Policy Committee, which makes committee assignments for House Democrats. And just when some of Reagan's budget-cutting proposals seemed to cost him some popularity, the attempt on his life in March 1981 made the president politically invulnerable. In short order, the House passed Reagan's budget-cutting package virtually intact.

Although the budget votes of May 1981 produced no more Democratic defections than in preceding years, the losses cost O'Neill dearly, on both policy and reputational grounds. Well before the crucial votes, he was severely criticized for giving into the CDF's demands. Liberals yelped when he confessed, a week before the first budget vote, that the odds of beating Reagan were not good. In the view of many liberals, whose demands for reform and participation underpinned O'Neill's style, the Speaker's strategy of inclusion was a failure. The comparatively small Democratic advantage in numbers made incohesiveness intolerable, yet positive inducements were no longer sufficient to guarantee cohesiveness. Thus, it seemed that O'Neill's leadership style failed him just when marginal differences made an effective style most critical, on the budget and tax votes of 1981.

After the first key vote in May, rumors of retirement again surfaced. Loyal Democrats demanded that their wayward colleagues be disciplined, and columnists had a field day, one predicting that O'Neill would not be re-

elected Speaker after the 1982 elections. Representative Les Aspin wrote his constituents that "I regret to say, Tip is reeling on the ropes . . . he's in a fog."⁴ Emotions ran so high that O'Neill felt compelled in June 1981 to announce his plans to run for reelection in 1982 and his intention to keep the speakership until at least 1984. In fact, O'Neill did not fight as hard as he could have on the budget resolution, but he was in a no-win situation: "I knew where my votes were. If I'd said we'd win by 35, 40 votes, they'd say: 'What the hell kind of a man is he? He hasn't any idea. He can't count the House.'"⁵

Nonetheless, O'Neill responded to the criticism by guiding a more concerted — if no more successful — leadership effort to block the budget reconciliation package and Reagan tax-cut plan. He sought to reduce the emotional fever among House Democrats by withstanding calls for punishing party defectors and avoiding situations and issues that further intensified intraparty factionalism. He also looked for opportunities to go back on the attack on legislation that united his party. The issue that did the trick was social security, which quickly drew Democrats together in late 1981 and put Republicans on the defensive.

O'Neill, of course, recognized the limitations of his style as much as anyone. Divisions and distrust within the party made task forces on budget resolutions useless or counterproductive in 1980 and 1981, so none were appointed. The use of the Steering and Policy Committee to discuss and endorse policy was discontinued at the same time. More and more decisions, especially about floor strategy, were made by a handful of party leaders, even though they were debated in various forums. This tactic was not just a way to avoid blame-calling within the party, although that certainly was an important consideration. It also reflected deep divisions among O'Neill's core liberal supporters about the best strategy for handling the Reagan attack, divisions that would not be bridged by confrontation and free-wheeling discussion.

The 1982 elections brought 26 more Democrats to the House, far more than necessary to cover the losing margin on the budget votes in 1981. The election results seemed to help rally House Democrats around the Speaker. Once again O'Neill had the strength to set the House agenda, present issues in ways that benefited his party, and compel the administration and Senate Republicans to bargain with him. O'Neill always maintained an open-door policy, but now he could afford the inclusive, accommodating approach of his first years in office. The 98th Congress brought back the regular use of task forces and other elements of the strategy of inclusion set aside in the 97th.

The 1984 election was a disaster for the Democratic presidential nominee, but only a handful of House Democrats lost, leaving O'Neill in control of the floor on major issues. Nonetheless, the Speaker adopted a somewhat defensive strategy, and waited for the Republican Senate or the administration to take the lead on budget cuts and tax reform. In any event, O'Neill's impending retirement stimulated others to assert themselves in leadership circles.

O'Neill's emphasis on positive inducements and inclusion was a necessary response to the environment of the post-reform House. For adapting his leadership style to that environment, he should be measured a success. But it is also clear that O'Neill's style, shaped as it was by the character of the House in the late 1970s, was not always

*"Although the budget votes
of May 1981 produced
no more Democratic defections
than in preceding years,
the losses
cost O'Neill dearly,
on both policy
and reputational grounds."*

*"But responsiveness
to demands,
as necessary as it might be
in the short term,
may undermine the value
of inducements
and inclusion
in the long term."*

appropriate to the specific political circumstances he faced at various points in his speakership. Nor could it be. Neither political foresight nor tactical fine-tuning is possible at such a level. Leadership style, especially one dependent on positive inducements, could not overcome weaknesses in party strength. Positive inducements were not a match for strong countervailing electoral pressures.

Institutional Changes

O'Neill leaves behind him new formal and informal practices that have altered the policy-making processes of the House. Since the late 1960s, the House has been moving toward greater egalitarianism in decision-making processes. Members sought regular participation in decision-making affecting political and parliamentary strategy as well as substantive policy choices. O'Neill responded to those demands, as we have seen, by making positive inducements and inclusion central features of his leadership style. But responsiveness to demands, as necessary as it might be in the short term, may undermine the value of inducements and inclusion in the long term. Signs of such a devaluation of leadership resources were already evident in the last years of O'Neill's speakership. Several developments are worth reviewing.

Committee Assignments

First, consider the Speaker's role in the committee system. O'Neill did little to directly change the permissive, service-oriented approach of twentieth-century Speakers to the

standing committees of the House. A 1977 plan to formalize an "early warning system" to give the Speaker more and better advance notice of legislative problems heading his way did not produce lasting results. Lack of cooperation from committees and their staff, as well as indifference on O'Neill's part, impeded creation of an effective communications network with leadership staff.

Committee assignments are one of the few concrete resources relevant to every party member that a Speaker has at his disposal. Since 1974, Democratic committee assignments have been made by the Steering and Policy Committee, which is chaired by the Speaker. The Speaker's control over assignments, however, was reduced as the size of Steering and Policy increased from 24 to 31 members during O'Neill's tenure. This expansion reflected O'Neill's responsiveness to the demands of other party leaders — the whip, the chief deputy whip, and campaign chairman — and the chairmen of the top standing committees for seats on the committee, but it cost him some control. Many of the new members came with agendas and commitments of their own that competed with the Speaker's. And decisions on assignments are made by secret ballot, which makes it very difficult to enforce agreements within the committee.

Furthermore, because Steering and Policy has granted more members their requests, they are less likely to be beholden to the Speaker for their committee assignments. The Speaker, who negotiates committee sizes and party ratios with the minority, created an all-time high of 1.78 committee seats per Democrat in his first Congress, and the number drifted up to 1.86 in the 99th. Moreover, "temporary" assignments, those requiring an exemption of assignment limit rules, increased in number as well. Both developments may have been consistent with O'Neill's approach of offering positive inducements to win support, although they are more appropriately viewed as O'Neill's willingness to accommodate members in most cases. Assignments to the top five or six committees remained highly contested, and the leadership continued to exercise discretion there. But overall, the credit gained by party leaders — particularly the Speaker — through the assignment process appears to have declined since the mid-1970s.

Task Forces

Speaker O'Neill, like his predecessors, was most active at the floor stage, where the Speaker's role in managing legislation is universally recognized as legitimate and essential to the functioning of the party and the House. Here O'Neill's strategy of inclusion centered on task forces. Typically, 25 to 30 members, a majority of whom were not from the committee of origin, were named by the Speaker and task force chairman to help the leadership and the bill manager pass legislation on the floor. Task forces opened participation in the support-gathering process to more junior members as well.

To some extent, the involvement of members outside of the committee of origin, and particularly of aggressive junior members, undermined the political sovereignty of standing committees. Occasionally, tactical decisions with substantive consequences were made by task force members, or at least with their advice and consent. Over the long run, task forces raised the visibility of some members in policy fields outside of their committees' jurisdictions,

*"The net effect
has been to broaden
the number of voices heard
in the writing of rules and to
ensure that elected party
leaders have a role
in shaping floor strategy
on major legislation. . . ."*

spread the credit for legislative successes among more members, and encouraged more critical review of committee products.

Multiple Referral

The referral of legislation to several committees by the Speaker was authorized for the first time in 1974 and became a well-institutionalized process under O'Neill. Previously, the Speaker was required to send a bill to the single committee with predominant jurisdiction over its contents. By giving the Speaker multiple referral authority, reformers hoped he could better manage the flow of legislation in the House and protect the interests of committees and factions formerly excluded from the process. During his tenure, O'Neill was granted or successfully asserted the authority to set time limits for committee consideration when legislation was sent sequentially to a series of committees, to multiply-refer legislation that was singly-referred originally but was amended so as to affect other committees' jurisdictions, and to designate committees of primary and secondary interest in cases of simultaneous or joint referral, with time limits for committees with a secondary interest in a bill. These powers substantially enhanced the Speaker's ability to expedite committee consideration and affect policy outcomes.

The use of multiple referrals increased rapidly under O'Neill. For example, the percentage of passed legislation that had been subject to multiple referral increased from 1.5 percent in the 94th Congress to 7.0 percent in the 98th. In many important policy areas — the environment, trade, en-

ergy, war powers, health costs — O'Neill used the referral power to further his party's legislative goals. In most cases, however, multiple referral was a routine response to the jurisdictional claims of committees, whose demand for referral cannot be ignored. Multiple referrals have had some side effects. The process sometimes stimulated disputes between committees and forced more problems onto the lap of the Speaker. And, to a certain extent, the process created expectations that compelled the Speaker to include more committees and members in the decision-making process, often slowing and usually complicating the crafting of legislation.

The Amending Process

The Speaker's control of the floor has expanded in important ways. First, the House, at O'Neill's urging, increased the number of days on which motions are in order to suspend the rules and pass legislation without amendment. The Speaker controls recognition for the purpose of offering such motions and so is in a position to expedite the consideration of legislation and protect it from amendments. O'Neill availed himself of this option frequently, nearly doubling the rate of use of suspension motions to pass legislation compared with his predecessor. Again, however, increased use of suspensions did not reflect so much the active use of discretion as a tool of the Speaker but O'Neill's willingness to try to accommodate members' and committees' demands.

Second, O'Neill established the clear principle of the Speaker's control of Rules Committee Democrats and the writing of rules governing the amending process on the floor. In 1975, the Speaker gained the right, with caucus approval, to name the Democratic members of Rules, increasing his potential control over rules. If O'Neill had not asserted that authority, however, the new power could have shriveled to insignificance. Rules members have policy and political interests of their own, after all, and they will pursue those interests if not challenged by the leadership. In fact, O'Neill deferred to Rules Committee Democrats on most legislation and tolerated some independence on their part. In 1983, for example, Rules Democrat Martin Frost suffered no negative consequences after he led the opposition on the floor to a rule strongly endorsed by the Speaker.

But, as O'Neill made clear in naming Democrats to Rules, he expected loyalty on key issues. In 1985, Rules Democrats resisted O'Neill's entreaties for a protective rule on a Ways and Means bill they opposed. After three meetings with O'Neill, committee Democrats finally conceded. Chairman Claude Pepper reported, "In the final analysis, the way it's set up now, we are an arm of the leadership."⁶ In the Ways and Means case, O'Neill supported the authorizing committee chairman's views. In other cases, he supported committee outsiders seeking to amend legislation on the floor. The net effect has been to broaden the number of voices heard in the writing of rules and to ensure that elected party leaders have a role in shaping floor strategy on major legislation reported from standing committees.

Third, O'Neill presided over a dramatic increase in the use of modified or restrictive rules, which do not prohibit floor amendments but do specify which ones are in order or their sequence of consideration. The number of restrictive rules rose partly in reaction to heightened Republican ef-

forts to devise floor amendments that would force Democrats to cast embarrassing votes. After Reagan's election, restrictive rules became a crucial tool O'Neill used to try to control the floor and his party's policy fortunes. Over one-fourth of rules since 1982 have been restrictive, up from 13 percent in Albert's last Congress. Open rules, those that do not restrict amendments, have fallen from nearly 90 percent to less than 70 percent of all rules. In this one vital way, the O'Neill speakership cut back on an avenue of participation for the rank-and-file. Much of the credit should go to former Rules chairman Richard Bolling and O'Neill aide Ari Weiss.

The Whip System

The House Democratic whip organization mushroomed in size during O'Neill's speakership. In Albert's last year, the whip system was comprised of the appointed whip, four appointed deputy whips (including the chief deputy whip), and 20 assistant whips elected by zones. Partly out of a desire to strengthen leadership control of the whips and partly in response to demands for representation by women, blacks, and junior members, O'Neill added 10 appointed at-large whips in 1977. By the start of the 99th Congress, the number of deputy whips had increased to nine and the number of at-large whips had increased to 32. Nearly 25 percent of House Democrats served in the whip system.

The expansion of the whip system, especially in the last three O'Neill Congresses, was more of a response to demands for access to the leadership than a savvy accumulation of leadership power. Whip meetings, necessary for the collection and dissemination of information within the

party, were held each week the House was in session during the O'Neill years. Tolerated by leaders because they were less unwieldy than the caucus alternative, whip meetings provided members an opportunity to express opinions about policy and strategy directly to party leaders and hear leaders' views on current political problems the party faced.

Finally, after years of active resistance, O'Neill did not object in late 1984 to making the whip's post elective for the 100th Congress. O'Neill and others had argued repeatedly that the Speaker and majority leader should be permitted to name their own whip on the grounds that they needed someone they could trust and that appointment was more likely to produce a regionally balanced leadership team. Proponents of an elective whip said that the position was a stepping stone to the top two positions and so should be chosen democratically. House Democrats now have five elective leadership positions, including the caucus chairman and secretary.

In Sum

Most party organs were expanded in response to demands from the rank-and-file and party factions during the O'Neill speakership. One that I have not mentioned, the so-called "Speaker's cabinet," was created in 1985 to answer demands from both conservatives and moderate activists for a larger voice in day-to-day decisions. Like the Steering and Policy Committee and the caucus, the cabinet turned out to be more form than substance as a location for substantive decisions about strategy and policy. In some cases, such as the use of task forces and enlargement of the whip system, a rationale based on leadership needs can be adduced. But, on balance, the expansion of party organs reflected a responsiveness to demands for access more than a deliberate search for new leadership tools.

The Next Speakership

Members, their staffs, and close observers tend to explain legislative outcomes in terms of factors that influenced the decisive votes, those cast by the last members to commit themselves. This approach is understandable, given that the last impression is the strongest impression and that the behavior of most members is taken for granted. In this context, the emphasis placed on leaders' personal qualities is reasonable. Personal qualities are important, especially at the margins, and margins count in legislative politics. I have deliberately de-emphasized Tip O'Neill's personality and political background so that I could direct attention to the central political features of his speakership. It is the political and institutional features surviving O'Neill that are important, and they suggest several lessons.

Beyond obvious cosmetic differences, I do not expect Jim Wright's basic leadership style to differ greatly from Tip O'Neill's. The structure of the House and the independence of the rank-and-file will require Wright to be permissive and reactive in his dealings with the standing committees and expansive in the creation of opportunities for member participation within the party. Intrusion of the leadership in committee deliberations cannot be expected except on only the most infrequent basis. While there is some recognition that the party's reforms of the 1970s may have been excessive in some particulars, the underlying egalitarian-

*"The structure of the House
and the independence of
the rank-and-file
will require Wright to be
permissive and reactive in
his dealings with
the standing committees. . . ."*

ism and demands for inclusion remain as strong as ever. Wright will probably be moderately more successful in the upcoming Congress than O'Neill was in his last years because of the modest Democratic gains in the recent election and the fragmentation of the Republicans that the end of the Reagan era and the 1988 political horizon will likely create.

Wright, like O'Neill, will have to depend on personal relations as his primary source of influence. But Wright is handicapped by weaker ties with colleagues; some express outright distrust of Wright. As majority leader Wright has worked hard to support his colleagues' campaigns and meet their needs in floor scheduling and in other areas. But a record of unpredictability and flashes of conservatism concern party liberals. The success of his speakership will depend on his ability to strengthen his personal relations with his colleagues generally and to earn the trust of the liberal majority in his party.

Concrete changes in party operations are likely to have only marginal impact on legislative issues, but two points should be considered. First, Wright should note the dilution of leadership resources. O'Neill's emphasis on accommodation and positive inducements gradually but perceptibly eroded the value of committee assignments, suspension motions, multiple referrals, appointments of various kinds, and other leadership tools. Continuation of those trends will eventually create a "self-service" leadership whose role will be seen but not appreciated by the rank-and-file. In the absence of effective negative sanctions, repeated use of positive inducements will further reduce their value and undermine the institutional significance of the speakership. A contraction of expected free services is not easy. But it is easier to do now in relative partisan prosperity than it will be in two or three Congresses. The cooperation of other top party leaders is required, of course, because they too have a tendency to expand preferments over time.

The dilemma for Wright is real and important. His short-term interest in bolstering his personal relations with suspicious colleagues pushes him toward an ever-increasing

use of positive inducements, while his longer-term interest is to husband his resources. Short-term needs may well win over long-term needs in the face of continuing demands from the rank-and-file. The best that can be hoped is that Wright will be on the alert for selective opportunities to reduce members' expectations for leadership services.

Second, Wright should consider carefully how to further develop the media as a resource of the Speaker. This is not just a public relations matter, as many House Democrats tend to see it, and it is not just a matter of going over the heads of members, presidential style, directly to the public. "News," as Woodrow Wilson said, "is the atmosphere of politics." The news, acquired through the media, has a pervasive effect. The Speaker's approach to the media affects his relations with other party leaders, committee leaders, and the rank-and-file. He therefore must retain personal control of the House Democrats' media strategy, adapting the use of the media to his own political needs and personality. That strategy may mean keeping a low profile at times when colleagues demand a coherent policy statement or floating off-the-record proposals when the television networks insist on a live interview from the Capitol steps.

Wright should not assume that the media's interest in the Speaker will continue indefinitely. Democratic control of the Senate will turn the attention of the media to prominent Senate party and committee leaders for the Democratic view of political events. To maintain the viability of the media as a leadership resource will require greater effort and creativity than was required of O'Neill.

For example, Wright will need to explore the more regular use of television, perhaps permitting cameras into his press conferences occasionally. Wright has some liabilities in his use of television: he comes across as a theater actor in a film actor's medium. His bushy eyebrows and occasional disingenuous smile sometimes undermine his credibility. But with proper care, Wright's ability to articulate views clearly — and with the right turn of phrase — can make television work to his advantage in ways that were not possible for O'Neill.

O'Neill leaves the speakership in good, but not perfect, shape for Wright. O'Neill's emphasis on creating an atmosphere in the House conducive to supporting the leadership, the discovery of manageable outlets for rank-and-file participation, the new controls over the floor amending process, and the stewardship of the party during the dark days of 1981 will not be forgotten. The House and its political environment do not stand still, however, and the next Speaker will have to adjust his style accordingly.

1. Joseph Cooper and David W. Brady, "Institutional Context and Leadership Style: The House from Cannon to Rayburn," *The American Political Science Review*, vol. 75 (June 1981), pp. 411–25. The propositions that follow are adapted from Cooper and Brady's argument.

2. The best treatment of O'Neill's leadership style during his first four years in office is Barbara Sinclair's *Majority Leadership in the U.S. House* (Baltimore: Johns Hopkins University Press, 1983).

3. Mary Russell, "O'Neill Rebounds From Setbacks in Party and on Floor," *Washington Post*, November 20, 1979.

4. Tony Kornheiser, "Tip O'Neill's Toughest Inning: The Sermon on the Mount," *Washington Post*, May 31, 1981.

5. Ibid.

6. Andy Plattner, "Controlling the Floor: Rules Under Chairman Pepper Looks Out for the Democrats," *Congressional Quarterly Weekly Report*, August 24, 1985, p. 1674.

*"Wright, like O'Neill, will have
to depend on personal
relations as his primary
source of influence.
But Wright is handicapped by
weaker ties with colleagues. . . ."*

Has the AT&T Break-Up Raised Telephone Rates?

Robert W. Crandall

IN JANUARY 1982, the federal government and AT&T shocked the American public by announcing that they had settled an eight-year-old government antitrust suit with a consent agreement that required AT&T to spin off its local telephone operating companies in two years. The telephone company would cease to exist. Consumers would no longer be able to buy their basic, local telephone service and long-distance services from the same company. The view that telephony was an integral service supplied most efficiently by a single company was being cast into the wastebasket of obsolete ideas.

Antitrust policy is supposed to enhance competition and lower prices to the consumer, but in the five years since the announcement of the AT&T settlement, telephone rates have risen sharply relative to general inflation. After falling continually for more than 20 years, the real cost of telephone service has actually gone up by about 15 percent since announcement of the divestiture. Local rates have risen even more rapidly, partly because of a deliberate attempt by the Federal Communications Commission (FCC) to alter the pricing structure for telephone service in the wake of the divestiture and the deregulation of long-distance service.

If antitrust and regulatory policies have succeeded only in raising local telephone rates, one might ask why consumers need this kind of "protection." Some even suggest that reassembling the AT&T monopoly is an idea worthy of consideration. But like Humpty-Dumpty, the monopoly cannot and will not be reconstructed. In this article, I argue that the recent changes in telephone rates are largely the result of economic and competitive forces. Subsidies and uneconomic pricing are slowly being wrung out of the telephone industry. Once the industry and its regulators complete their adjustment to the new competitive realities in telecommunications, consumers may find that they benefit substantially from a system driven by market forces instead of negotiations between a monopolist and its state and federal regulators.

Regulation of Telephone Rates – The 1960s and the 1970s

For decades, telephone service has been regulated at the federal and state levels by commissions whose concerns have been more related to popular concepts of fairness than to economic efficiency. Until the 1970s, few users or policy-makers objected if long distance subsidized local telephone service as long as AT&T, its local operating companies, or the other local operating companies that accounted for 10 to 15 percent of total telephone subscribers did not appear to earn an excessive rate of return. Local rates could be priced on a flat monthly basis despite the possibility that this policy would subsidize the loquacious. Long-

Robert W. Crandall is a senior fellow in the Brookings Economic Studies program and the author of books on the auto and steel industries, regulation, and industrial pollution. He is currently working with Bruce M. Owen on a book on telecommunication policy in the wake of the AT&T divestiture.

*"Some even suggest that
reassembling the AT&T
monopoly is an idea
worthy of consideration.
But like Humpty-Dumpty,
the monopoly
cannot and will not
be reconstructed."*

distance calls could be priced at a flat rate per mile even though such pricing penalized callers on low-cost dense routes and subsidized those in rural areas.

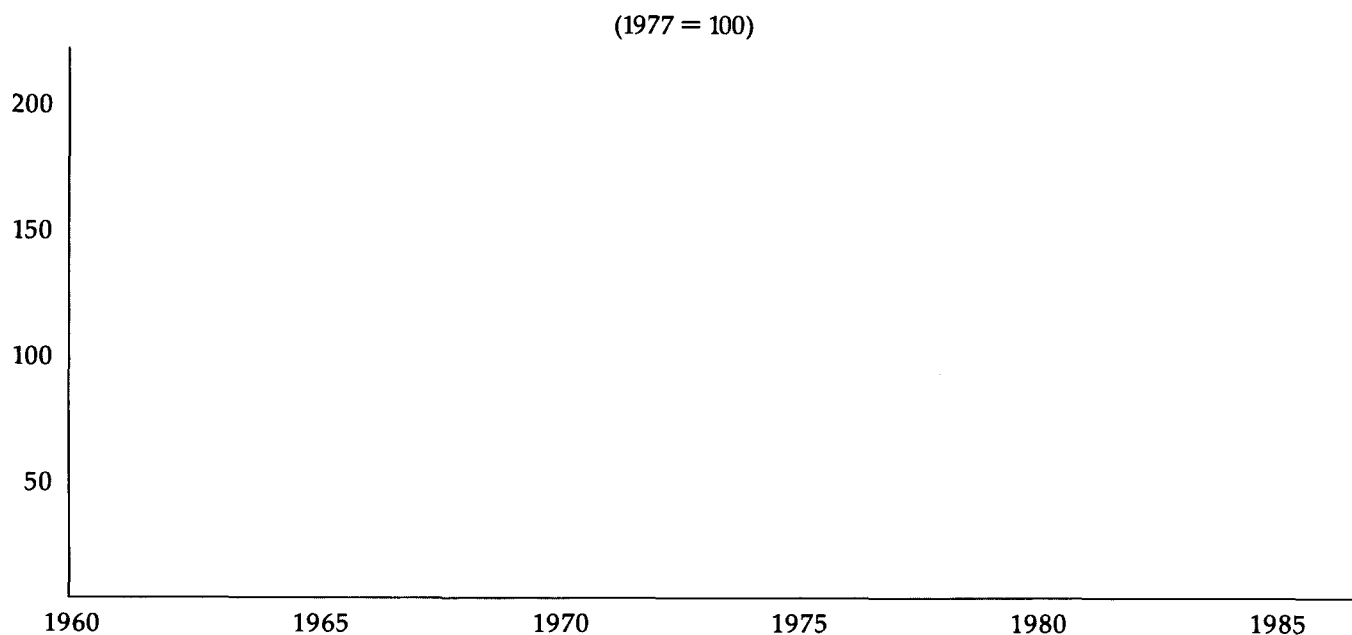
As transmission costs declined in the 1960s and 1970s, state and federal regulators did not allow long-distance rates to fall proportionately, and a larger share of local-service costs were allocated to long distance. But as long as the overall cost of telephone service kept dropping, few complained. It is unclear whether this was AT&T's preferred pricing strategy, but in the political arena of regulation the company did not object mightily as long as it was permitted to keep its long-distance monopoly.

Throughout the 1960s and 1970s, overall telephone rates fell substantially relative to inflation. Between 1960 and 1980, real telephone rates fell by more than 50 percent (see figure 1). In part, this decline was caused by rapid technological progress. Productivity rose much more rapidly in the telephone industry than elsewhere in the economy. In addition, rates were suppressed in the inflationary 1970s by a regulatory process that relied on historical-cost accounting. The result was that all telephone companies' common stocks fell in value relative to their book value in the 1970s, often by as much as 50 percent (see table 1).

The distortions in telephone rates and changing technology began to invite potential competition in the 1960s. At first, this competition was limited to private lines used by large businesses and to simple devices attached to telephone lines. By the mid-1970s, however, competition had spread to most terminal equipment — such as PBXs and telephone handsets — and, more importantly, to long-distance service. Companies such as MCI and Sprint began to compete actively for long-distance customers.

Figure 1.

*The Inflation-Adjusted Index of Telephone Service Costs, 1960–85**



*Consumer Price Index for telephone service deflated by Consumer Price Index–Urban.
Source: Bureau of Labor Statistics.

Table 1.
Market/Book Ratios for Telephone Operating Company, Electric Utility,
and Industrial Equities, 1964–85

Year	Market/Book Value						Inflation***
	AT&T	GTE	Rochester Telephone	United Telephone	Electric** Utilities	S&P400 Industrials	
1964	1.92	2.95	2.26	3.26	2.22	2.23	0.013
1965	1.63	3.34	2.33	3.45	2.21	2.26	0.017
1966	1.43	2.90	2.07	3.16	1.97	1.87	0.029
1967	1.25	2.54	1.84	3.26	1.86	2.17	0.029
1968	1.28	2.33	2.06	3.32	1.64	2.25	0.042
1969	1.14	1.77	1.56	2.15	1.56	1.96	0.054
1970	1.10	1.80	1.91	1.73	1.23	1.92	0.059
1971	0.98	1.72	1.87	1.70	1.27	2.04	0.043
1972	1.12	1.55	2.16	1.83	1.14	2.13	0.033
1973	1.02	1.23	1.33	1.29	0.99	1.74	0.062
1974	0.87	0.82	0.74	1.04	0.66	1.13	0.110
1975	0.94	1.17	0.80	1.12	0.68	1.42	0.091
1976	1.15	1.36	0.99	1.48	0.78	1.57	0.058
1977	1.01	1.22	1.00	1.36	0.86	1.27	0.065
1978	1.00	1.04	1.02	1.26	0.80	1.20	0.077
1979	0.82	0.99	0.98	1.26	0.74	1.23	0.113
1980	0.73	0.95	1.00	1.06	0.65	1.43	0.135
1981	0.87	1.08	1.28	1.19	0.67	1.18	0.104
1982	0.86	1.33	1.17	1.13	0.77	1.33	0.061
1983	0.88	1.30	1.25	1.09	0.89	1.52	0.032
1984	1.13*	1.12	1.28	1.17	0.84	1.51	0.043
1985	1.41*	1.43	1.43	1.40	—	1.79	0.036

*For AT&T and divested regional holding (operating) companies.

**Average of 24 electric utilities in Moody's Utility Manual.

***Rate of change in Consumer Price Index—Urban.

Source: Company reports; Standard & Poors; Bureau of Labor Statistics.

The new competition in long-distance service began to exert downward pressure on rates during the late 1970s (see table 2). AT&T responded by attempting to reduce its private-line rates and by trying to frustrate the new competitors' efforts to reach customers through AT&T-owned operating companies. These activities induced the Justice Department and the new competitors to file a series of antitrust suits, most of which have now been settled. The Justice Department suit was filed in 1974 and settled by the 1982 decree that forced AT&T to divest itself of its local operating companies.

Regulation in the 1980s

The 1970s ended with one last burst of inflation that carried over into 1980. By 1981 inflation began to subside, allowing state and federal regulators to let telephone rates rise relative to inflation. As a result, telephone equities began to recover from their 1980 lows although they did not regain their mid-1960s premium over historical book values (see table 1). It is interesting to note that the same recovery oc-

curred in the equities of electric utilities, which are also regulated under a historical-cost accounting regime.

The inflation-adjusted Consumer Price Index for telephone service has risen by 15 percent since 1981 after falling by more than 3 percent a year in the previous 20 years. I have conducted an empirical analysis of the relationship between real telephone rates and the determinants of telephone company costs over the period 1960 through 1985. In estimating this relationship, it is important to include a separate variable for the overall rate of inflation. This variable is negatively related to real rates and adds much more to the explanation of telephone rates from 1960 through 1985 than a simple dichotomous variable reflecting the 1982 consent decree in the AT&T antitrust case. My findings suggest that the interaction of macroeconomic and regulatory forces has been most responsible for the recent rise in telephone rates, not the abrupt change in the structure of the telephone industry caused by the antitrust decree.

There can be no doubt, however, that the *structure* of telephone rates is undergoing a dramatic change and that the change is a direct result of government policy. Long-

Table 2.
Real Producer Price Indexes for
Telephone Service, 1972–85

Year	Interstate Toll	Intrastate Toll	Local Residential	Local Business
1972	100.0	100.0	100.0	100.0
1973	96.9	97.2	96.9	97.9
1974	87.4	91.4	92.3	94.3
1975	86.8	88.5	88.1	91.0
1976	87.4	92.3	87.4	91.1
1977	83.3	91.1	82.4	84.5
1978	78.2	84.6	78.3	80.8
1979	69.6	75.8	71.1	74.1
1980	63.3	67.2	65.0	67.5
1981	63.2	63.2	66.3	68.4
1982	65.9	63.1	69.6	70.5
1983	64.4	63.9	70.8	72.5
1984	59.9	64.0	73.2	74.5
1985	55.7	63.0	74.9	75.6

Note: All indexes deflated
by Consumer Price Index–Urban.
Source: Bureau of Labor Statistics.

*"There can be no doubt,
however, that the
structure of telephone rates
is undergoing a
dramatic change
and that the change is a
direct result
of government policy."*

distance rates are continuing to fall in real terms while local rates rise (see table 2). The price of local service is now more likely to be based upon the number of calls made and the length and duration of these calls. Telephone receivers and other terminal equipment are no longer leased from the local phone company, and many subscribers now own their equipment. Subscribers are much more likely to be charged substantial installation fees because local telephone companies are no longer able to capitalize these installation costs in their balance sheets. Considerable discussion continues on the necessity of substituting flat monthly "subscriber line charges" for the access charges long-distance companies pay the local companies to originate and terminate calls.

All of the above changes may be attributed to the emergence of competition that has followed deregulation in the telephone industry, not simply to the consent decree separating AT&T from its operating companies. The uneconomic pricing decisions that regulators promoted or sanctioned in the 1960s and 1970s have come unraveled. Competition can destroy cross-subsidies in a manner that makes life very difficult for legislators and regulators who are still held accountable by the erstwhile beneficiaries of such subsidies. To understand the current pressures on regulators in this more competitive era, however, one has to understand the uneasy equilibrium that has evolved from regulation, entry, and competition.

Monopoly or Competition?

In its earliest form, the telephone industry may have been a "natural" monopoly. Stringing paired copper wires between homes or businesses and telephone switching centers may initially have been more efficient when conducted by a single monopolist than by a number of warring competitors. But even during those years, was it clear that AT&T should also monopolize the manufacture and distribution of handsets or other terminal equipment? Our local gas utility may have a natural monopoly in distribut-

ing gas, but it does not try to control the distribution of water heaters, furnaces, and kitchen ranges. Thus, even from the beginning, the limits of the telephone monopoly should have been a matter for public debate.

The long-running debate over AT&T's right to produce the telephone equipment used in the delivery of its services is therefore understandable. In 1949, the Justice Department brought an antitrust suit against AT&T and Western Electric, its manufacturing subsidiary, for monopolization. Among the government's concerns was the fear that Western Electric had an unfair competitive advantage because of its connection with the AT&T operating companies. The suit was finally settled in 1956 by a consent decree that prohibited AT&T from participating in any market other than regulated telecommunications. This consent decree was perceived to be a major burden to AT&T. As we shall see, AT&T's decision to sacrifice its operating companies in the 1982 settlement was the price it had to pay to have this 1956 decree vacated.

In the 1950s, technological changes began to occur that greatly complicated the problem of regulating the telephone monopoly. Users began to demand the right to attach foreign devices to their telephone lines. At first, these were simple devices. Eventually, however, subscribers began to demand the right to connect their own answering machines, computer modems, and private branch exchanges to the lines. Users even wanted to own their handsets — perhaps even handsets that were unlike any offered by the local telephone company.

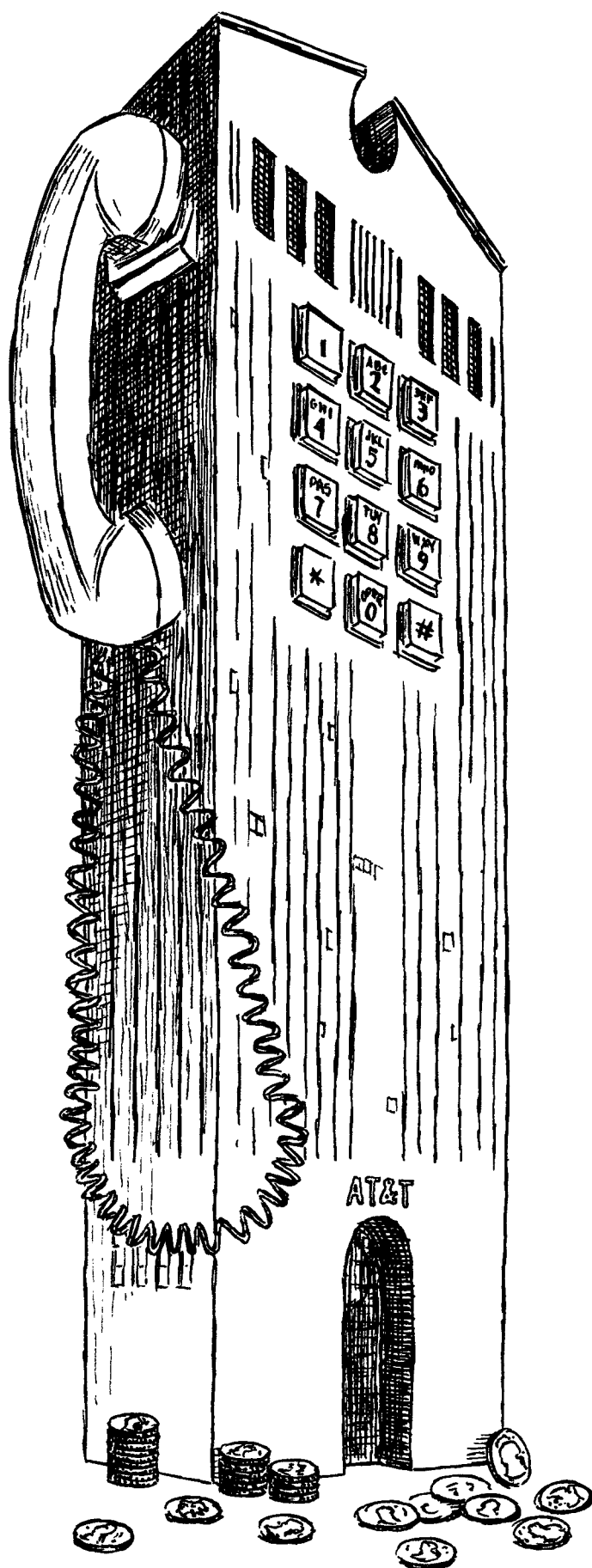
Technological change also altered the nature of telephone signal transmission. Long-distance calls began to be transmitted by microwave radio, a technology with modest economies of scale relative to the market on dense routes. Why shouldn't large users be allowed the option of acquiring their own microwave transmission facilities? And if those companies could opt out of AT&T services for certain uses, why shouldn't smaller companies be allowed to buy similar services from parties other than AT&T?

The Federal Communications Commission responded to the demand for entry into long-distance communications and terminal equipment — in some cases prodded by the courts and the White House. In the late 1960s, the FCC began to allow competitive entry into private-line (point-to-point) services and the installation of terminal equipment on the ground that these services and products could be supplied most efficiently by a competitive market. AT&T's offering of these services and products, however, continued to be regulated. The FCC refused to allow new entrants into the "network" or switched long-distance services because it was unpersuaded that competition was a viable and efficient means for delivery of these services. Local service, regulated by state public utilities, also remained under monopoly control.

The entire regulatory process came unglued in the mid-1970s when MCI entered the switched long-distance market without FCC permission. The FCC had authorized MCI to provide private-line service, but it had not contemplated that MCI would try to offer ordinary long-distance service. At first, the FCC tried to block MCI's expansion, but the commission was defeated in one court proceeding after another because it failed to demonstrate that competition in long-distance markets was either infeasible or socially undesirable.

*"The FCC refused
to allow new
entrants into the 'network'
or switched long-distance
services because it
was unpersuaded that
competition was a viable
and efficient means for
delivery of these services.
Local service, regulated
by state public utilities,
also remained
under monopoly control."*

By the late 1970s, therefore, the FCC and the courts had transformed the telephone monopoly into a set of competitive long-distance carriers and equipment vendors, each connecting their services or equipment to the lines of franchised local (and intrastate) monopolists. AT&T could play in the long-distance market subject to regulatory restraints, and it did so with such aggressive effect that it became the target of a wave of antitrust suits. But the 1956 decree continued to prohibit AT&T from competing in the new world



of mixed communications-computer services. Most of the competitors were unhappy with this state of affairs. AT&T felt handicapped by its inability to compete in the burgeoning computer market. AT&T's competitors complained that they were at a disadvantage as long as AT&T controlled their access to customers. Nearly everybody wanted the rules changed.

The regulation-induced distortion in relative telephone rates had little political effect when the entire network was virtually controlled by a single company. But when competitors began to appear, individual rates mattered very much. Should AT&T be free to price its private-line service or long-distance service at any level it chose? Would it not choose to behave in a predatory manner in pricing these services? How was Centrex — an AT&T-developed service that substitutes for a PBX or a customer's own internal network — to be priced? What services should the local companies offer MCI in connecting this upstart to the local circuits necessary to originate and complete its competitive long-distance service? What rates should be charged for these connections?

The simple answer to all of the above questions is that the FCC and the state commissions did not have even the most fundamental idea of how to begin to set relative rates efficiently and to establish fair ground rules for the new world of competitive telecommunications markets. The FCC has groped about for nearly two decades to try to separate the various costs of telecommunications services from each other, but the nature of the services and the enormous pace of technological change in the industry continue to make the commission's task difficult if not impossible.

The new competition in terminal equipment and long-distance service had predictable effects. The regulators could no longer attempt to subsidize basic monthly service from excess charges from long-distance service. As long as the FCC and the state commissions combined to keep long-distance rates artificially high, new competitors would eagerly enter this market. As MCI, Sprint, and others began to make inroads into AT&T's erstwhile long-distance monopoly, AT&T tried to fight back through competitive rate reductions (that were often delayed or denied by the FCC) and actions designed to frustrate its competitors' access to customers through AT&T's local operating companies. Given that these operating companies served roughly 90 percent of all households in the country, it was hardly surprising that MCI was moved to bring an antitrust suit against AT&T. The Justice Department brought its own suit, in effect charging AT&T with actions that were all but mandated by the structure of telephone rates. The FCC and state regulators had artificially raised long-distance rates to help defray the cost of local service; AT&T could hardly be expected to be complacent in defending itself against entry threats in the high-priced long-distance market.

The Divestiture

In 1982, AT&T agreed to its own dismemberment in settlement of the government's 1974 antitrust suit. In return, AT&T was given the right to retain Western Electric and its research arm, Bell Laboratories; the 1956 consent decree that barred AT&T from entering new computer-related businesses was vacated; and the divested operating companies were prohibited from manufacturing equipment

and offering long-distance or information services. The 1982 decree required that all AT&T operating companies be divested on January 1, 1984. But the operating companies obviously began to plan for life without AT&T in early 1982, and their interests and AT&T's interests began to diverge then.

The decree was designed to separate the suppliers of access to local subscribers — the AT&T operating companies — from those offering long-distance and other information-age services. As a result, the divested operating companies are not allowed to compete with MCI, AT&T, Sprint, or other companies in most of the long-distance market. To preserve fair competition, the local operating companies are limited in much the same way that AT&T was under the now defunct 1956 decree; in fact, the restraints on the operating companies are even more severe than those in the 1956 decree.

In the three years since divestiture, the FCC, Congress, the Justice Department, and the U.S. district court that oversees divestiture have been engaged in constant policy struggles over telephone regulation. The court decree requires that the divested Bell operating companies follow a specific schedule to provide equal access for all long-distance carriers, but the operating companies can only provide access, not competition.

In this new world, AT&T is free to compete for any business except local exchange service. It remains a regulated carrier, but it has been allowed and even required to reduce long-distance rates to a point where some of the new carriers have been forced to leave and others are clearly suffering. The divested operating companies are owned by seven regional holding companies who want to be freed from the regulatory straitjacket imposed by the court decree that prohibits them from entering long-distance services, equipment manufacture, or information services.

The FCC, for its part, continues to be very receptive to competitive solutions to the industry's problems. It has relaxed some of its requirements for structural separations between regulated and unregulated businesses of interstate carriers (notably AT&T). And its chairman, Mark Fowler, has talked openly of encouraging experiments in deregulation of even local service. But the major problem facing the FCC has been to restructure telephone rates to fit the new competitive environment.

Divestiture and Rate Structure

Many critics of the AT&T divestiture argue that it has unleashed a number of forces that have simply raised local telephone rates with no offsetting benefits. First, critics say that divestiture has sacrificed economies of size and scope in operating the telephone network. Second, it has forced recognition of the obsolescence of the equipment owned by AT&T and the operating companies, thus raising the depreciation charges that must be recovered in setting telephone rates. Third, it has increased "local" charges because flat rate customer access fees have been substituted for usage-sensitive access charges levied on long-distance companies. Finally, it has provided the divested Bell operating companies with a convenient excuse — their new status — to seek higher rates from state commissions.

Of these arguments, only the third has much merit. There are no convincing studies that demonstrate joint

*"The FCC, for its part,
continues to be very receptive
to competitive solutions
to the industry's problems.
It has relaxed
some of its requirements
for structural separations
between regulated and
unregulated businesses
of interstate carriers. . . .
And its chairman, Mark Fowler,
has talked openly of
encouraging experiments
in deregulation
of even local service."*

*“... the evidence
seems to contradict
the widespread belief that
deregulation and divestiture
have raised telephone rates.”*

economies in the provision of local and long-distance service. Nor can one quibble with the necessity for changing the depreciation policies that led to the accumulation of obsolete equipment on the books of regulated carriers. In the early 1980s, AT&T actually had to write off several billion dollars of this equipment. And the argument that divestiture, not the winding down of inflation, caused rates to rise after 1981 is not very convincing, as I have argued above.

There can be no doubt, however, that the FCC is attempting to alter the structure of telephone rates in a very fundamental manner. Before long-distance deregulation and the divestiture, a large share of local operating company costs was assigned to long-distance services. These costs were recovered from long-distance rates through a complex settlements and separations process that now has been partly replaced by a set of access charges paid by the long-distance carriers to the local companies for providing access to customers. Although the local telephone companies are the most obvious route to these customers, they are no longer the only route.

In recent years, new technologies — cable, microwave, and cellular radio — have given long-distance carriers access to customers. Now that AT&T is independent from its operating companies, it is much more likely to utilize these alternative technologies to “bypass” the local telephone companies altogether. There is considerable disagreement about the current or potential extent of this bypass problem, but the FCC is clearly worried that high access charges are a major inducement to bypass the local telephone companies, thereby threatening to reduce local company revenues and to require higher local rates.

To ease the potential bypass problem, the FCC has imposed a set of flat monthly “subscriber line charges” on residential and business customers and lowered long-distance carriers’ access charges. These subscriber line charges are currently \$2 a month for residences and \$6 for multiline business subscribers. Obviously, this policy change has raised the local subscriber cost and reduced long-dis-

tance rates as the competitive long-distance carriers pass their savings in access charges through to customers.

A number of groups, particularly those representing low-income or elderly consumers, bitterly oppose the FCC-imposed subscriber line charge. They argue that the threat of bypass is not sufficiently great to warrant such a shift in the cost of service from long-distance users to those using the telephone more intensively for local calls. And others fear that the higher “local” rates will cause the number of subscribers on the system to decline, thereby sacrificing an important policy goal of “universal” service.

In fact, data collected by the Census Bureau show very little erosion in the share of households subscribing to or having access to telephone service. The percentage of families with a telephone has gone up since divestiture, from 91.4 percent in November 1983 to 91.9 percent in November 1985. Among income categories, the increase was greatest — 1 percent — in households with incomes under \$5,000; the sharpest decline — 1.5 percent — was in households with incomes between \$12,500 and \$17,500. Perhaps the reason for this stability is the development of “lifeline” services that allow low-income users to have a telephone at a low monthly cost with charges for all calls in excess of a small number a month. Perhaps it is simply that the cost of telephone service is still a very small share of the monthly income of all but a few Americans.

Conclusion

Deregulation and the consequent AT&T divestiture have certainly caused confusion and upheaval in the telephone industry. Not only is the consumer now free to make his own decisions on many of the dimensions of his telephone service, but in most cases he is required to do so. He must choose the number and type of receivers he desires from competitive equipment sellers. He is asked to choose his long-distance carrier. He may buy his telephone answering machine from someone other than his local telephone company, and he may even buy a car phone from an independent company. His monthly telephone bill provides him with a befuddling and excruciating degree of detail. All of this contrasts with the simple life of buying everything from AT&T just 10 years ago.

However complicated deregulation and divestiture have made the consumer’s purchase of telephone services, it does not appear that they have actually increased the average level of telephone rates. Rather, deregulation has led to a rationalization of rates with the charge for individual services beginning to approximate more closely the apparent cost of service. This adjustment has reduced cherished subsidies for a few consumers — particularly talkative subscribers in rural regions with many friends in their local dialing areas. Just as airline deregulation may have increased the cost of service for an occasional traveler between Kankakee and Keokuk while lowering the cost and increasing the frequency of service virtually everywhere else, so has the government-forced change in the telephone industry lowered some rates while raising others. In the long run, these changes will prove to have been beneficial since they more closely reflect the relative cost of service. For the present, about all we can say is that the evidence seems to contradict the widespread belief that deregulation and divestiture have raised telephone rates.

'Neither a Panacea nor a Trojan Horse'

The Comparable Worth Controversy

By Henry J. Aaron
and Cameran M. Lougy
\$7.95 paper.

THE COMPARABLE WORTH CONTROVERSY

Henry J. Aaron & Cameran M. Lougy

WHILE THERE IS NO DOUBT that women have suffered from labor market discrimination, the authors of a new Brookings study conclude that even extensive use of the concept of comparable worth could not change many aspects of this discrimination. Where discrimination can be proved, comparable worth, or equal pay for work judged to be of equal value, "is only one of several remedies and often neither the most relevant nor the most powerful," Henry J. Aaron and Cameran M. Lougy write in *The Comparable Worth Controversy*. Their judgment is that "comparable worth is neither a panacea nor a Trojan horse threatening free enterprise capitalism."

Aaron, a senior fellow in the Economic Studies program at Brookings and professor of economics at the University of Maryland, and Lougy, a graduate student at the Woodrow Wilson School of Public and International Affairs at Princeton University, review key elements of the issue: evidence of discrimination against female workers, the way wages are actually set by labor markets, and job evaluation methods. Their analysis leads them to several important conclusions:

- Half or more of the difference between male and female earnings "can be explained by factors unrelated to any possible discrimination by individual employers." At the same time, considerable evidence strongly suggests "the past prevalence and lingering importance of such discrimination. . . ."

- Comparable worth cannot correct some forms of discrimination. Where women are denied entry to particular jobs or promotions that they merit, for example, remedies such as affirmative action and civil rights litigation are at least as promising as "the most expansive acceptance of wage adjustments based on comparable worth."

- Job evaluation and wage setting based on job characteristics are "inherently arbitrary." Courts, therefore, should not require that wages be set solely according to the results of evaluation studies but should instead use these studies as one piece of evidence in determining the presence of discrimination.

- Use of comparable worth in public-sector wage setting or in private-sector collective bargaining "is likely to reduce slightly the discrepancy between male and female earnings."

- Widespread increases in women's real wages resulting from adjustments based on comparable worth would slightly increase overall wage growth for several years. For some women, that growth would result in reduced employment opportunities in some traditionally female jobs.

"Our major conclusion is that the intensity of rhetoric lavished on the issue of comparable worth is grossly excessive," write Aaron and Lougy. "Like most ideas [comparable worth] can be driven to extremes. If applied in a limited way, it holds some promise for offsetting a small part of the effects of discrimination on women's earnings."

The Minimill: A Modern-Day Phoenix

Up from the Ashes: The Rise of the Steel Minimill in the United States

By Donald F. Barnett
and Robert W. Crandall
\$9.95 paper, \$26.95 cloth.

DESPITE A NEARLY 20 PERCENT decline in the U.S. steel industry's total capacity in the past decade, one segment is showing vigorous signs of life. Small producers called minimills, which manufacture steel from scrap instead of iron ore, have doubled their capacity in the same period in competition with both larger domestic and foreign steel producers.

The prosperity of the entrepreneurial minimills, now numbering more than 40, is based on their ability to adjust to new technologies, to use plentiful scrap metal,

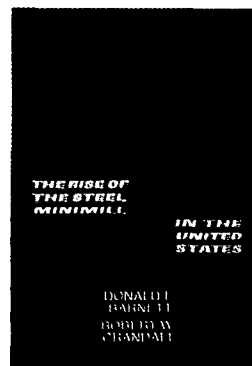
to offer narrow product lines, and to realize higher labor productivity than the larger integrated steel companies. This surprising growth is documented by Donald F. Barnett and Robert W. Crandall in their new book, *Up from the Ashes: The Rise of the Steel Minimill in the United States*. Crandall is a senior fellow in the Brookings Economic Studies program; Barnett is an independent consultant and the former chief economist of the American Iron and Steel Institute.

Minimills, which now account for about 20 percent of all raw steel production in the United States, began in the 1960s with the disadvantages of small-scale operations and "fairly inefficient untried technology." The most important factor in their success has been the minimills' ability to adjust quickly to new technology. Furthermore, continuous operational improvements have allowed the minimills to produce more and more steel with the same size or smaller work force.

Building on these strengths, "each new generation of mills aimed at a new market, was more cost competitive, and used a superior technology," Barnett and Crandall write. Their "cost advantages became so great that they could aim for nationwide markets, launching a frontal assault on the integrated firm." As a result, minimills have virtually eliminated the integrated producers from the carbon bar and wire rod markets and are now beginning to invade the market for large structural shapes and even sheet products.

In documenting the higher labor productivity of the minimills, the authors note that the "number of man-hours per ton required to produce wire rods in a typical U.S. minimill is half of that in a typical U.S. integrated mill and 60 percent of that in a Japanese integrated mill." Because of their higher productivity gains and their lower raw material costs, minimills are also able to compete successfully with foreign imports. "As the U.S. dollar has fallen in 1986," the authors state, "the minimills have become virtually invulnerable to foreign competition, and the [domestic] integrated producers have become more cost competitive." The authors predict that minimills should be able to double their current share of the U.S. market by the year 2000, shipping 40 percent of all U.S.-produced steel.

The minimills are an example of a domestic enterprise that has risen virtually from the ashes of a seriously troubled industry without governmental assistance. Crandall and Barnett suggest that other industries and policy-makers should consider whether it may be more productive to encourage new, entrepreneurial companies than to protect and rejuvenate large producers.



Inflation, Wages, and Economic Stability

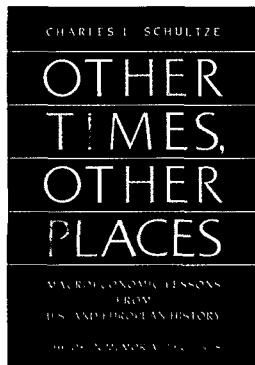
IN THESE PENETRATING ESSAYS, Charles L. Schultze, a senior fellow in the Brookings Economic Studies program, compares inflation, wage behavior, and economic stability in different historical eras and among different countries to bring new insight into these three areas of economic controversy.

Schultze's analysis of how inflation responds to changes in aggregate market conditions covers more than a century and shows that the United States does not easily generate large and sustained increases in inflation. He observes that it took three inflationary shocks—the policy mistakes of waging the Vietnam War without a tax increase, followed by two successive and massive increases in energy prices—coming in quick succession to create the inflation of the 1966–80 period. Schultze predicts that inflation will rise somewhat from its low 1985 level as the dollar declines. "But," he writes, "with a little luck and only average good sense and political courage in managing our monetary affairs, the decade ahead should not see a repetition of the circumstances that shaped the profile of the 1970s."

Other Times, Other Places: Macroeconomic Lessons from U.S. and European History

By Charles L. Schultze
\$7.95 paper, \$15.95 cloth.

*"The . . . view that U.S.
real wages are more flexible than
European real wages in
response to supply disturbances
is not borne out
by the empirical evidence. . . ."*



Schultze also compares the behavior of wages in the United States and several European countries and concludes that real wages in Europe are neither as excessive nor as downwardly rigid as is commonly believed. "The widely accepted view that U.S. real wages are more flexible than European real wages in response to supply disturbances is not borne out by the empirical evidence from fitting wage and price equations to the data of the past twenty years," Schultze writes, adding that "it is unwarranted to identify downwardly rigid real wages as the chief culprit in Europe's economic performance."

In the final essay, Schultze concludes that the U.S. economy has been much more stable since World War II than it was in earlier decades and offers three reasons for the improved performance. First, he contends that erratic changes in the money supply did not cause the economic fluctuations of the late nineteenth and early twentieth centuries, as many have argued, but that economic fluctuations stemming from other causes led to changes in the money supply. In the postwar period, the Federal Reserve has provided a more stable monetary system. Second, he argues that the greater availability of consumer credit, aided by the larger relative size of liquid assets, has helped smooth consumption since World War II. Furthermore, the stabilizing influence of automatic reductions in federal revenues and increases in unemployment compensation during recessions and the automatic rise of federal revenues and fall of unemployment compensation during expansions also smoothed consumption. Last but not least, Schultze found that business investment has been substantially less volatile since World War II.

Other Times, Other Places: Macroeconomic Lessons from U.S. and European History is based on a series of highly technical lectures Schultze delivered in October 1985. The lectures are part of a series established at Yale University in memory of Arthur M. Okun, who was a senior fellow at Brookings from 1969 until his death in 1980.

The Center for Public Policy Education at Brookings

National Issues Forums

Designed for an audience of about 100 people, each forum explores one issue of critical social, economic, and political significance. Attendees exchange views with White House officials, members of Congress, scholars, and other key Washington decision-makers at these one-day sessions open to the national news media.

- ☐ *Changing the Tort Liability Litigation System: Protecting Manufacturer and Consumer*
February 4, 1986
- ☐ *Deficit Reduction and U.S. Defense Policy*
March 18, 1987
- ☐ *The Implications of the Growth of Foreign Direct Investment in the U.S.*
April 1, 1987
- ☐ *The Growing Role of China in U.S. Economic Relations*
April 22, 1987
- ☐ *Expanding the Competitiveness Debate: Trade Issues for the Next Decade*
May 27, 1987

The fee of \$295 per program includes a luncheon and a reception following the forum. Lodging is not included.

Executive Leadership Seminars

These two-day seminars are designed for business executives who need to understand federal policy issues and processes and government executives who need to understand the corporate environment. Each informal, off-the-record session fosters the development of new perspectives on issues of concern to business and government.

- ☐ *The Federal Budget for Fiscal Year 1988*
February 24–26, 1987
- ☐ *Crises and Issues in the Financial Services Field*
March 10–12, 1987
- ☐ *Science, Technology, and Industrial Productivity*
April 7–9, 1987
- ☐ *U.S. Defense Policy: Priorities for the 1990s*
May 12–14, 1987
- ☐ *The U.S. in the International Economy: Domestic and International Economic Choices*
June 16–18, 1987

Each seminar runs from Tuesday dinner through Thursday lunch. The program fee of \$910 includes meals but excludes lodging.

Name _____

Title _____

Company _____

Address _____

City/State/Zip _____

Phone _____

☐ Please enroll me in the programs checked above. Enclosed is payment of _____.

☐ Please put me on your mailing list to receive detailed information about the programs checked.

Send to:

Mr. David Fingerman, Center for Public Policy Education
The Brookings Institution
1775 Massachusetts Avenue, N.W., Washington, D.C. 20036
(202) 797-6162



1775 MASSACHUSETTS AVENUE N.W. WASHINGTON D.C. 20036

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED